ACCRUAL ACCOUNTING — ITS ORIGIN AND ROLE IN GOVERNMENT MANAGEMENT

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CHAPTER I

INTRODUCTION

This is a study of the accrual basis of accounting, its application in the Federal Government and, in particular, its status in Navy accounting. Considerable attention has been devoted in recent years to improvement of the financial management process in the Government. Among the measures to promote better management have been the efforts to institute accounting on the accrual basis. The first Hoover Commission recognized the need for it during its studies. The accounting improvements enacted under the Title IV amendments to the National Security Act in 1949 and the Budget and Accounting Procedures Act of 1950 implied the use of accrual accounting. The second Hoover Commission definitely recommended adoption of the accrual basis, and Congress legislated such a requirement under Public Law 84-863 in 1956. However, despite the existence of this legislative precept, the Navy's fund accounting system continues to operate under the obligation and expenditure basis of accounting.

The second Hoover Commission also recommended that appropriations by Congress be expressed in terms of annual accrued expenditures instead of obligations. In 1958, Congress passed a modified version of this proposal, authorizing the use of

accrued expenditure limitations superimposed on the obligation type appropriations. However, this was never in fact done, and the authorizing legislation, Public Law 85-759, expired in 1962. This raises the question of whether accrual accounting is a realistic measure when Congress continues to provide appropriations expressed in terms of obligational authority and fund control must necessarily function in the language of obligations. What benefit does accrual accounting offer for Government management?

In this paper an attempt is made to trace the origin of the accrual accounting concept in the Federal Government, to examine its meaning and evaluate its value for management purposes. The concept of appropriations on the basis of accrued expenditures is also studied in order to resolve the question of possible conflict between accrual accounting and fund authorizations on the obligation basis.

To gain a comprehensive understanding of the underlying purpose and meaning of accrual accounting in the Federal Government, the approach taken has necessarily been of a broad nature, encompassing a review of the major accounting and budgeting improvement measures on a government-wide basis. No attempt is made to present detailed mechanics of the accounting process, since the purpose is to evaluate the meaning of accrual accounting from a managerial perspective, not to explore the techniques involved. Following a broad review of the subject from a government-wide view, the treatment is then narrowed to a consideration of what the Navy has done to improve its accounting

processes and the status of accrual accounting in the Navy.

In Chapter II, a general discussion of accounting and its managerial uses is presented. This is to provide background material and develop an appreciation for the way in which accounting fits into the broader scheme of management. The nature of accrual accounting in private industry is examined here. Chapter III covers the subject of accounting in the Federal Government and reviews the forces that prompted reforms in budgeting and accounting. The important legislation which bears on Federal Government accounting and which led to the requirement for adopting the accrual basis is set forth. Also, the controversy and legislation regarding accrued expenditures limitations are examined and evaluated. In Chapter IV, the accrual accounting concept is explored in greater depth, its purpose in management control is discussed, and the status of accrual accounting on a government-wide basis is reviewed. Chapter V turns to the subject of accounting in the Navy, dealing with the accounting improvements which have been instituted, the endeavors to proceed towards implementation of accrual accounting, and the influences on Navy accounting stemming from Department of Defense programs and policies. The summary and conclusions of the study is presented in Chapter VI.

The primary research sources utilized were public documents, reports, textbooks, and articles in periodicals dealing with accrual accounting in particular and with the broader subjects of accounting, budgeting, and financial management in

the Federal Government. This research was supplemented with interviews with officials of the Office of the Navy Comptroller to gain a better understanding of the accrual accounting concept, information on the Navy's accounting improvement efforts, and assistance in obtaining research materials. Lectures and discussions in the Navy Graduate Financial Management Program have also provided insight into some of the accounting and budgeting concepts and procedures which are discussed.

CHAPTER II

ACCOUNTING AND ITS RELATIONSHIP TO MANAGEMENT

It is the purpose of this chapter to present a concise discussion of some general concepts and characteristics of accounting from a managerial point of view. This will serve to set a background and form a basis of understanding for the concepts which are later developed.

Accounting Defined

In a discussion of accounting, it seems appropriate at the outset to present a definition of the subject as a point of departure. Perhaps the most authoritative definition is that of the Committee on Terminology of the American Institute of Certified Public Accountants:

> Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.[1]

Smith and Ashburne offer a variation that seems to add even greater meaning. They say:

> Accounting is the science of recording and classifying business transactions and events, primarily of a

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[1]American Institute of Certified Public Accountants, Accounting Terminology Bulletin No. 1 (New York: American Institute of Certified Public Accountants, 1953), p. 9.

> financial character, and the art of making significant summaries, analyses, and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgements.[1]

In this second definition, the communication aspect of the accounting process has been introduced. As a medium of communication, accounting is an element of the total information system available to internal management and to other interested parties outside of the organization.

As Henry Albers explains:

> Accounting is a specialized language system that is used to measure the consequences of organizational activities and to communicate such information to executives and others.[2]

In this view, the accounting system is a feedback mechanism providing information, principally in financial terms, on the status of an enterprise and the results of operations. It stands to reason that the integrity and utility of the system and the data it produces depends largely on how well and accurately it conveys a true image and meaning of the "real thing" it represents. If the system of symbols comprising the accounting information complex do not communicate a correct and meaningful picture of the underlying object of interest, the utility of the system is questionable.

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[1]C. Aubrey Smith and Jim G. Ashburne, Financial and Administrative Accounting (New York: McGraw-Hill Book Company, 1960), p. 2.

[2]Henry H. Albers, Organized Executive Action (New York: John Wiley & Sons, 1961), p. 390.

Within the broad field of accounting there are various specializations or areas of emphasis, including financial accounting, managerial accounting, and cost accounting. Financial accounting in private industry is sometimes classified as general accounting and is fundamentally historical in perspective. It embraces the functions of collecting, analyzing and recording data of a financial nature, and the preparation and interpretation of periodic statements, such as the balance sheet, operating statement, and retained earnings statement, to report the financial status and results of operations for the information of the owners, creditors and other interested parties.

Managerial accounting, in contrast, is devoted to the application of accounting information and techniques to the active management of the enterprise. The distinction between financial accounting and managerial accounting has been described as follows:

> Administrative accounting, or managerial accounting, is based on the concept of accounting as a method of management or as a tool by which managerial effectiveness is enhanced. Although it deals primarily with the same financial data, it is not confined to financial data. It seeks to assure scientific managerial planning and sound managerial decisions by furnishing historical data and projections of the consequences of alternative decisions. It seeks to make managerial control more effective by encouraging planning and keeping the plan constantly before management's attention, comparing performance with the results anticipated.[1]

In other words, the perspective of managerial accounting is to aid management in effective administration of the enterprise.

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[1]Smith and Ashburne, *op. cit.*, p. 11.

It involves the use of various tools and techniques such as budgeting and cost accounting to facilitate control of operations, to compile performance information for comparison against standards or yardsticks, to analyze data to determine reasons and responsibility for deviations from plans, and to reinforce the competency of management's decisions.

Cost accounting is commonly associated with factory type accounting methods for development of unit costs, such as the familiar job order or process cost systems. However, the general field of cost accounting is much broader than this. As Nickerson explains:

> . . . the field has been expanded in areas such as cost control, budgeting, and cost determination for a variety of managerial uses and has been broadened to include administrative expenses and distribution costs and the cost and control problems of nonmanufacturing business. Although cost accounting has many ramifications, its central theme is to provide information, largely in the area of costs, which will be useful in controlling the operations of a business in a broad sense.[1]

Smith and Ashburne consider that " . . . since a major effort in all accounting is the determination of costs, all accounting is cost accounting, in the true sense of the word."[2] Dealing primarily with segments of an enterprise, such as functional areas or departments, rather than the entity as a whole, cost accounting primarily serves internal management rather than outside interests. One of the principle objectives of cost accounting is to furnish

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[1]Clarence B. Nickerson, Managerial Cost Accounting and Analysis (New York: McGraw-Hill Book Company, 1962), p. 1.

[2]Smith and Ashburne, op. cit., p. 394.

information useful in keeping costs under control. Control implies not simply the compiling of cost data but also the exercise of supervision over operations to which they relate. Wilber Haseman has written:

> The classification of costs by area of responsibility is an important aspect of this problem, because costs are controlled by controlling the persons causing the costs to arise. By grouping costs according to areas of responsibility management will have a basis for judging the effectiveness of subordinates and for isolating the causes for inefficiency.[1]

Underlying the field of cost accounting is the concept of the flow of costs. Costs arise by virtue of a payment of cash, the incurrence of a liability, or the consumption of an asset. In the course of operations they flow from one form to another, e.g., from asset to expense, and accurate cost accounting requires that expenses of the period be separated from those costs that remain in the form of assets to be carried forward to the subsequent accounting period. Expenses of the period represent the costs of goods and services that have been consumed, that is, the expired costs. As explained below, the proper allocation of expenses to the period to which they apply is predicated on use of the accrual basis of accounting.

The Nature Of Accrual Accounting

Although this paper is concerned with accrual accounting in government, a clear understanding of its nature should begin with a review of its application in commercial and industrial accounting

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[1] Wilber C. Haseman, Management Uses of Accounting (Boston: Allyn and Bacon, 1963). p. 404.

since it is a basic and fundamental concept. One of the foremost objectives of accounting in private enterprise is the determination of net income or loss for the accounting period. Net income, or profit, is simply the difference between total revenue and total expenses for the period of measurement. A net loss occurs when total expenses exceed total revenue. To determine net income or loss, the revenue earned during the accounting period must be matched against the expenses incurred in earning such revenue.

The nature of accrual accounting and its importance in the accurate computation of net income can be illustrated by comparison with the cash basis of accounting. "On the strict cash basis, income is equivalent to cash received; expense is equivalent to cash paid out."[1] In other words, income and expenses are recognized only upon the receipt and disbursement of cash. Income is recorded in the accounting records when cash is collected and expenses are recorded at the time of payment. The cash basis does not produce a true measurement of operating results because it fails to recognize income that may have been earned though not yet collected, and it overlooks expenses that may have been incurred but which will be paid in a subsequent accounting period. The acts of receipt and payment of cash obviously are not valid criteria for determination of income and expense of an accounting period.

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[1]Smith and Ashburne, op. cit., p. 60.

Under the accrual basis of accounting, net income is computed by matching revenue realized during the accounting period against costs expired during the period. Revenues and expenses under the accrual basis are defined as follows:

> The revenues of a business enterprise are the gross earnings during the period in question from the delivery of goods or the rendering of services to customers. Revenue is earned or realized at the time the goods or services are delivered to the customer regardless of the time when the order is received or when the cash is collected from the customer. Consequently, revenue earned is not the same thing as cash receipts or orders received.
>
> . . . .
>
> The expenses of a business enterprise are the costs of the goods and services consumed by the enterprise in the earning of revenue. As an enterprise carries on its operations, various goods and services are purchased, paid for, and consumed. Costs occur at the time goods or services are purchased or acquired. Expenses occur at the time goods or services are consumed. The actual cash payment for goods and services may take place at some other time, before or after purchase or consumption. Consequently, the expenses of a period are not the same as the cash payments or purchases of that period.[1]

From the foregoing it can be seen that accrual accounting differs from the cash basis in that it focuses on revenue earned and expenses incurred instead of revenue collected and expenses paid. The statement of income on an accrual basis is therefor predicated on:

> . . . an assignment of revenues and expenses as between past, present, and future operations, a nice distinction between capital and revenue expenditures, and procedures for holding up revenue received or expense incurred but not considered to be chargeable to the current period.[2]

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[1]Wilber C. Haseman, op. cit., pp. 7-8.

[2]Smith and Ashburne, op. cit., p. 62.

The accountant:

> . . . rejects the circumstances of receipt or payment of cash as criteria for associating either income or expense with a period. Instead, he adopts the accrual basis, which rests on the concepts of realization and expiration . . .[1]

Accounting's Use In Management

Management has been defined by authorities in the field in a variety of ways and the many approaches that have been taken will not be explored here. It will suffice to accept the view of one recognized authority who considers management as the job of getting things done through people and comprised of the following five functions:

> 1. Planning - the selection, from among alternatives, of enterprise objectives, policies, procedures, and programs.
>
> 2. Organizing - the grouping of activities necessary for accomplishing enterprise purpose, the assignment of these activity groupings to managers with the necessary authority for undertaking them, and the establishment of authority relationships horizontally and vertically in the structure to assure the degree and kind of coordination desired.
>
> 3. Staffing - the selection and training of subordinates.
>
> 4. Directing - the overseeing of subordinates in the undertaking of their assigned duties.
>
> 5. Controlling - the measurement and correction of activities of subordinates to make certain that plans are transformed into action.[2]

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[1] *Ibid.*, p. 61.

[2] Harold Koontz, "The Planning and Controlling of Organizational Activities," *Current Issues and Emerging Concepts in Management* (Boston: Houghton Mifflin Company, 1962) p. 119.

In this context, accounting serves management principally in the planning function and the control function. In the planning process, management is concerned with setting the objectives of the organization and determining how available resources will be utilized. Planning is, in a sense, a process of developing an optimum mix of alternative programs. Various possible courses of action are examined and decisions are made from the alternatives presented. Plans for the future are, to a large extent, bred from past experience and, since accounting records are the primary source of financial history, they naturally play an important role in planning. Both qualitative and quantitative considerations influence the planner and the accounting system is a primary source of the quantitative data used in planning. Accounting data is commonly used to measure the costs of resources implicit in the various alternatives under consideration in a planning problem. When values are assigned to goals and objectives they are commonly expressed in accounting terms, and when plans are put into effect they are usually translated into budgets which are expressed in the language of accounting, for:

> Financial information is the common denominator through which objectives and plans are expressed, and it provides a means for measuring the performance of executives and operating departments.[1]

In the control function, the accounting system acts as a "feedback" to collect information about performance and inform management of the results of operations. Reports and statements produced by the accounting system provide a basis for making day-to-day

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[1] Albers, _op_. _cit_., p. 147.

operating decisions and for planning future action. Cost data is an aid to management in decision-making and in comparing performance results against resource consumption.

Indeed, management control is one of the primary reasons for the existence of an accounting system and should be a major consideration in design of the system, in determination of the type and form of input data, how it is processed, and the type of reports that are produced.

> A well-designed accounting system should produce reports that fulfill as nearly as possible the needs of the recipient for information about the operations under his control or responsibility . . .
> . . . .
> It should be apparent that an accounting system exists not for itself alone, but only as it may be able to serve management in the business of which it is a part. Hence the starting point in discussing, designing, or changing an accounting system or any of its parts should be the question of how management can best be served.[1]

It follows that, in judging the merits of an accounting system, a principle criterion is how well it serves the needs of management. In this regard, accurate cost data and profit projections are of major importance to the manager since competent managerial actions depend upon a full knowledge of the implications of decisions on cost and profit performance.

Comparison of Industry to Government Management

In private industry, the profit criterion is of foremost importance, management is geared to that objective, and the accounting process is structured to produce accurate periodic

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[1]Francis E. Moore and Howard F. Stettler, *Accounting Systems for Management Control* (Homewood, Illinois: Richard D. Irwin, 1963), pp. 5-6.

measurements of financial results. Competition provides the stimulus for managerial efficiency and cost control. In contrast, government administrators operate in an environment lacking the incentives inherent in the competitive atmosphere of private business and without the efficiency yardstick provided by the profit goal. Without the impelling influences of competition and profit motive, administration in government must seek other tools to promote efficiency and economy in the use of resources entrusted to it by the general public.

A major responsibility of all officials engaged in the administration of government activities is to insure that programs are pursued at the lowest necessary cost commensurate with effective achievement of the program objectives. In the quest of economy and efficiency, considerable attention has been devoted to management's responsibilities for control of costs in government operations. Efforts have been directed towards improved financial management practices that contribute towards greater productivity and cost reductions. In the Federal Government, there has developed in recent years:

> . . . an increasing emphasis on costs at all management levels - on costs determinations and on cost-based budgeting. At the same time better productivity measures are being developed . . . to provide a more reliable basis for measuring work productivity throughout the Federal Government. Another very encouraging development is the progress being made in cost-benefit analysis relating the costs of particular public services to money measures of the benefits derived. All of these developments are contributing to a more rational order of managerial decisions.[1]

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[1]Lyman Bryan, "Federal Budgets and Private Budgets," The Journal of Accountancy, CXVII (January 1964), p. 14.

Prominent in the endeavors to create greater cost consciousness are the reforms that have been introduced into the Government's budgeting and accounting processes. Some of the major developments in this direction are discussed in Chapter III.

CHAPTER III

REFORMS IN FEDERAL GOVERNMENT ACCOUNTING

Accounting in the Federal Government has undergone significant changes in recent years. Much of the emphasis in this reform can be characterized as an effort to reorient the accounting processes towards managerial applications. One matter which has received particular attention is the effort to promote the development and use of cost information, with de-emphasis of obligation accounting which had been the customary basis for financial control. In the following discussion, some of the characteristics of government accounting are examined, followed by a review of the influences and recent legislation which have had a bearing on Federal budgeting and accounting.

Characteristics of Government Accounting

In a general sense, accounting in government serves two broad functions: (1) to render reports in compliance with legal and administrative requirements, and (2) to furnish data for management and control of the governmental unit. Burkhead describes these as the "accountability" function and the "management" function.[1] For accountability purposes, he says that government

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[1]Jesse Burkhead, Government Budgeting (New York: John Wiley & Sons, 1959), pp. 358-359.

accounting systems should:

> (1) . . . be designed to show compliance with legal provisions.
>
> (2) . . . the commitment and disbursement of monies must be related to budget accounts embodying requests for new expenditure authority. That is, budgeting and accounting must be components of an integrated system of fiscal control.
>
> (3) Accounts must be set forth in such a way as to permit a determination of the adequacy of custodianship of monies and assets under the responsibility of administrative officials.
>
> (4) Accounts must be maintained on a basis which will permit an independent audit extending to all records, funds, securities, and property.[1]

For management purposes, he suggests that the accounting system should:

> (5) . . . provide a full disclosure of financial results, including the measurement of revenue and the costs of activities, programs and organizations.
>
> (6) . . . provide management at all levels with information for planning and direction. This includes, but is not restricted to, cost measurement.
>
> (7) . . . incorporate effective procedures for internal audit and control of operations and programs.
>
> (8) . . . provide information necessary for economic analysis and planning of governmental activity. This information should be presented in a form that is useful for both executive and legislative purposes.[2]

The accountability functions primarily serve to control the acts of public officials, safeguard public property and funds, reveal the status of spending authorizations, and inform legislative bodies, control agencies and the general public about the operations of government units and how public funds are applied.

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[1] Ibid., p. 358. [2] Ibid., p. 359.

While the importance of these functions are evident and not to be denied, the management functions are also essential since they are the means which enable responsible government officials to manage the operations of an agency effectively and economically. Both the accountability and the management purposes are vital to the public interest. However, ". . . historically, in the establishment of government accounting systems, accountability has been given primary if not sole emphasis."[1]

A distinguishing feature of governmental accounting is the existence of two broad groups of accounts, commonly referred to as the "budgetary" accounts and the "proprietary" accounts. The budgetary accounts are peculiar to the accounting systems of municipal, state, and federal governments, having ". . . no counterpart in commercial accounting practice."[2]

The budgetary series of accounts are designed to serve fund control purposes, for recording transactions which affect the status of fund authorizations, e.g., appropriation accounts, obligations incurred, and expenditures. The proprietary accounts, on the other hand, are those normally associated with general accounting practice, embracing the accounts for assets and liabilities, revenues and expenses. In the same manner as found in commercial accounting, they serve to record the government unit's cash, property and other assets, its liabilities, equity,

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[1] Ibid.

[2] Eric L. Kohler and Howard W. Wright, Accounting in the Federal Government (Englewood Cliffs, New Jersey: Prentice-Hall, 1956), p. 22.

income and expenses.

Until recently, the emphasis in Federal Government accounting was almost exclusively on the budgetary group of accounts, and financial management was concerned mostly with keeping expenditures within fund limitations.

Pressure for Reform

In tracing the attempts to install accrual features in the accounting systems of the Federal Government, it is interesting to note that efforts in this direction were made as early as 1926. In that year, the General Accounting Office issued Circular 27 which was a statement of procedural requirements for the executive branch agencies in accounting for appropriations and funds. These regulations were based on the provisions of section 309 of the Budget and Accounting Act of 1921 which invested the Comptroller General with authority to prescribe the forms, systems, and procedures for appropriation and fund accounting in the Federal Government. At the time of issuance of Circular 27, virtually all of the agencies maintained only single-entry type accounting systems. Financial accounting for property and cost accounting systems were almost nonexistent.[1]

Among the provisions of Circular 27 were requirements that each agency establish a double-entry system of accounting, a general-ledger account structure for each fund under its control, and the accrual basis of accounting. It envisioned that each

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[1]Howard W. Bordner, "Impact of General Regulations 100 on Accounting in the Federal Government," The Federal Accountant, XI (June 1962), pp. 62-92.

agency would maintain a single integrated accounting system embodying obligation, cash, and cost accounting features. In 1943, the contents of Circular 27 were republished, with but minor revisions, as General Regulations 100. However, despite the existence of these regulations from as early as 1926, very little real progress was made in achieving their objective. The underlying concepts were not generally accepted, and few of the executive agencies actually installed accounting systems which met the prescribed requirements.[1] Since the Comptroller General's authority was limited to appropriation and fund accounting, there was no basis for enforcement of the regulations.

The first Hoover Commission, during the period 1947 to 1949, focused renewed attention on the fiscal processes of the Federal Government. Although the Commission's main concern was on organizational structures and relationships between the various agencies, its recommendations also stimulated a number of reforms in the Federal Government's budgeting and accounting systems. In appraising the status of the Government's accounting processes, the Task Force on Fiscal, Budgeting, and Accounting Activities reported:

> . . . we think it is obvious that a basis of accounting that never shows the Government's true revenues and expenses for any year, and that does not provide positive control of assets, liabilities, and appropriations, is thoroughly inappropriate to the Government's needs. We suggest, therefore, that the cash basis of accounting be completely ruled out and that the accrual basis be adopted for all of the Government's accounts . . .

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[1] *Ibid.*, p. 63.

> . . . we cannot too strongly urge the establishment of an appropriate system of accounting kept on the accrual basis. If such a system is not adopted, there can be no hope that the Congress ever will be clearly informed concerning the financial affairs of the Government to be able to exercise fully intelligent control of the Government's "purse strings."[1]

Also, during this period, the Joint Program for Improving Accounting in the Federal Government became an active influence. Undertaken in December of 1947 under the joint leadership of the Comptroller General, the Secretary of the Treasury, and the Director of the Bureau of the Budget, this program devoted its initial efforts, as suggested by its title, towards modernization of the Government's accounting procedures. The program still functions, has been widened in scope to embrace the fields of programming, budgeting, and reporting, and since 1959 has been titled The Joint Financial Management Improvement Program.

As a result of the work of the first Hoover Commission and the Joint Program for Improving Accounting, two major pieces of legislation were enacted that contained provisions that have had a profound impact on financial management in the Government, they were the title IV amendments to the National Security Act enacted in 1949, and the Budget and Accounting Procedures Act of 1950. Neither expressed an explicit legislative requirement for adoption of accrual accounting, but both required far reaching reforms in the Government's budgeting and accounting practices.

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[1]U.S. Commission on Organization of the Executive Branch of the Government, Task Force Report on Fiscal, Budgeting, and Accounting Activities, January 1949, pp. 103-104.

Public Law 81-216

The Title IV amendments to the National Security Act, Public Law 81-216, were directed towards improved financial management in the Department of Defense. To this aim, it required the establishment of comptrollers in the military departments to integrate budgeting, accounting, progress and statistical reporting, and internal auditing functions. Among its major provisions relating to budgeting and accounting were the following:

1. Introduction of the "performance budgeting" concept, under which budgets are prepared so as to focus on the cost of performance of readily identifiable functional programs and activities, with segregation of operating and capital programs.

2. Establishment of "working capital" funds to finance inventories of supplies and equipment, and to provide working capital for industrial-type and commercial-type activities.

3. Establishment of "management funds" to facilitate operations financed by two or more appropriations.

4. Maintenance of property records on both a quantitative and a monetary basis.

In the words of Frederick Mosher:

> . . . Title IV was a significant enactment of the Congress. It was the first Congressional expression in behalf of the "performance budget" idea . . . Its prescription of Comptrollers at the departmental levels was a new departure, expressive particularly of the new emphasis upon accounting and fiscal management. Most of all,

> however, its emphasis upon economy and efficiency in military management remains its dominating feature . . .[1]

Describing the underlying concept of performance budgeting, Mosher says:

> . . . It is simply that when we budget and authorize funds we are providing for things to be <u>done</u> rather than for things to be <u>bought</u>. Moneys are furnished for activities and <u>functions</u> rather than for purchases and payments. Almost our entire experience and heritage in government financial control is the other way around. In a sense, this amounts to substituting ends for means as the focal points of financial planning and control.[2]

In short, the idea of performance budgeting is to center attention on the functions, programs, or work to be accomplished and their costs. Also termed "program budgeting," its full development assumes the employment of an accrual basis of accounting. The interrelationships of accrual accounting and program budgeting is evident from the following statement by Kohler and Wright:

> . . . As accrual accounting gains in acceptance, so will program budgeting. When accrual accounting has been uniformly instituted, "program" might well be dropped from the term. The budgeting of an agency's programs based on ordinary accrual accounting will be the natural and normal form of budgeting and, hence, just budgeting.[3]

<u>Budget and Accounting Procedures Act of 1950</u>

The import of the Budget and Accounting Procedures Act of 1950 can be appraised from the statement of the President

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[1]Frederick C. Mosher, <u>Program Budgeting: Theory and Practice</u> (New York: Public Administration Service, 1954), p. 41.

[2]<u>Ibid</u>. p. 81.

[3]Kohler and Wright, <u>op</u>. <u>cit</u>., p. 105.

when he signed the bill, that " . . . this is the most important legislation enacted by Congress in the budgeting and accounting field since the Budget and Accounting Act, 1921 was passed almost 30 years ago."[1]

Prominent among the features of the 1950 Act, insofar as concerns budgeting and accounting, were the following actions:[2]

1. Performance budgeting, which had previously been prescribed for the Department of Defense by Title IV, Public Law 81-216, was extended to all Government agencies. Emphasis was placed on construction of budget requests in terms of functions and activities, with justifications to be based to the maximum extent possible on workload and unit-cost data.

2. The principles and objectives of the Joint Program to Improve Accounting in the Federal Government were incorporated into law. The Comptroller General, the Secretary of the Treasury, and the Director of the Bureau of the Budget were charged with responsibility for pursuing a continuous program for improvement of accounting and financial reporting.

3. Established the concept whereby the head of each executive agency was responsible for development of the agency's accounting system in conformity with principles, standards, and requirements prescribed by the Comptroller General. Prior to this action,

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[1]U.S. Congress, Senate, Committee on Government Operations, Financial Management in the Federal Government, 87th Cong., 1st Sess., February 13, 1961 (Washington: Government Printing Office, 1961), p. 80.

[2]*Ibid*, pp. 80-85.

the Comptroller General had prescribed specific procedures for appropriation and fund accounting under the authority of the Budget and Accounting Act of 1921. The 1950 Act gave recognition to the need for flexibility in design of accounting systems to meet the unique and varying needs of the individual agencies by placing responsibility for systems development on the agencies themselves, within a framework of basic principles and standards to be set by the Comptroller General.

Section 113 (a) of the 1950 Act set forth clearly the intent of Congress as to the fundamental purposes that should be served by Government accounting systems. Under this section, agency accounting systems are required to be designed so as to provide:

> . . . full disclosure of the financial results of the agency's activities; adequate financial information needed for management purposes; effective control over and accountability for all funds, property, and other assets . . .; reliable accounting results to serve as the basis for the preparation and support of the agency's budget, and for providing financial information required by the Bureau of the Budget . . .; and suitable integration of the agency accounting with the central accounting and reporting of the Treasury Department.[1]

Although an accrual accounting requirement did not appear, per se, in the wording of the Budget and Accounting Procedures Act of 1950, there was clear intent for reform of accounting processes in line with the recommendations of the joint accounting improvement program and the first Hoover Commission. The authority vested in the Comptroller General to prescribe accounting

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[1] Ibid., pp. 83-84.

principles and standards provided the requisite wherewithal to impose accrual account requirements on the executive agencies. However, further legislative interest arose subsequent to passage of the 1950 Act that was to lead to a more explicit mandate for accrual accounting.

<u>Second Hoover Commission</u>

A reexamination of the Government's financial management processes was conducted by the second Hoover Commission during the period 1953 to 1955. In commenting on the activities of this second Commission in the area of accounting, two of the Commission's staff members reported disappointment over the progress that had been made in gaining the objectives of the earlier accounting improvement programs. They said:

> . . . through the Budget and Accounting Act of 1950, Congress imposed on the Bureau of the Budget, the Treasury Department, and the Comptroller General legal responsibility for the development of accounting methods designed to provide operating information. Up to the present, however, only a few steps have been taken for the implementation of these programs, and these steps have not accomplished much.[1]

Three closely related subjects received particular attention by the Task Force on Budget and Accounting. These were, budgeting based on costs, appropriations in terms of estimated annual accrued expenditures, and accrual accounting. While reaffirming the validity of the performance budget concept of the Budget and Accounting Procedures Act of 1950, the task force called attention to the fact that most budgets were formulated on the

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[1]Neil MacNeil and Harold W. Metz, <u>The Hoover Report 1953-1955</u> (New York: The MacMillan Company, 1956) p. 58.

basis of estimated obligations to be incurred and had no necessary relation to costs to be incurred. The Commission urged the continuation of performance budgeting supported by information on program costs and accomplishments.

The Commission also laid heavy emphasis on the desirability of changing the basis of Congressional appropriations from the obligation basis to an accrued - expenditure basis. ". . . the present method must be changed, it found, if congressional control over the purse is to be effective."[1]

Regarding accounting, the Commission recognized that the installation of the cost-based budgeting concept would necessarily require accrual accounting and, in commenting on management's need for financial information, they said;

> . . . Accounting and reporting systems must be responsive to the needs of management. This requires that they be designed to show the results of operations as they apply to organizational units. Accounting limited primarily to accounting for obligations and expenditures does not fulfill these requirements. Modern accounting systems should be installed in the executive agencies and maintained on the accrual basis. Such systems would permit the preparation of periodic financial statements for each agency showing what it owns and what it owes, as well as the current costs of the various operations.[2]

Twenty five recommendations were made by the second Hoover Commission relating to budgeting and accounting. Included were recommendations for use of cost-based operating budgets for agency management; support of performance budget classifications

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[1]Ibid., p. 55.

[2]U.S. Commission on Organization of the Executive Branch of the Government, Budget and Accounting, A Report to the Congress, June 1955, p. 36-37.

with information on program costs and accomplishments; synchronization of organizational structures, budget classifications and accounting systems; formulation of executive agency budgets on a cost basis; appropriations in terms of estimated annual accrued expenditures, simplification of the allotment system; and accelerated actions to install monetary property records in the accounting systems. They also recommended adoption of the accrual basis of accounting to show currently, completely and clearly all of the Government's resources, liabilities, and costs of operation.

The Cooper Committee

Further support for cost budgeting and accrual accounting also developed during this period from an Advisory Committee on Fiscal Organization and Procedures in the Department of Defense. Known as the "Cooper Committee," this group, comprised of industry and government representatives, was established in 1953 to review the accounting and financial practices of the Department of Defense and the military services.

Cost budgeting was one of the principle recommendations of the Cooper Committee. They regarded the use of budgets prepared on the basis of costs as essential to effective financial administration and the creation of cost consciousness on the part of administrators in the military services. In lending support to the cost-based budget concept as a means for fixing the attention of administrators on value received for resources consumed, the Committee said:

> . . . other means of financial control based on obligations and expenditure budgeting do not measure performance and tend to emphasize the availability of funds in terms of

unobligated or unexpended balances and this is not equally conducive to economy.[1]

Regarding accounting systems, the Committee recommended that:

> . . . a double-entry system of accounts be maintained and that the accrual method of accounting be followed in the recording of transactions to the extent that it will significantly contribute to more meaningful financial data.[2]

Turning its attention to the question of obligation type appropriations, the Cooper Committee advised that adoption of the cost budgeting concept as proposed in its report would not necessarily require a change in the practice of appropriating funds in terms of obligational authority. Costs could be reconciled to obligations by showing changes in inventories, other working assets, and unliquidated obligations between the beginning and end of the year, so that fund authorizations could still be stated on an obligation basis. However, their report stated:

> . . . in order to gain the maximum benefits from budgeting and accounting on a cost basis, the Committee suggests that consideration be given to a basis of appropriating that would be more closely related to costs in the sense of goods and services received than the basis now used. Although some provision for Congressional authorization to contract for long lead time C.O.D. orders would be needed, the cost approach would focus attention on the resources to be received and those to be used in the budget year.[3]

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[1]U.S. Office of the Secretary of Defense, Financial Management in the Department of Defense, Report of Advisory Committee on Fiscal Organization and Procedures, October 1, 1954, p. 23.

[2]*Ibid.*, p. 37. [3]*Ibid.*, p. 23.

Public Law 84-863

Culmination of the endeavors to gain a legislative basis for cost-based budgeting and accrual accounting in the Federal Government was reached with the enactment of Public Law 84-863, which was approved by the President on August 1, 1956. This Act, the terms of which are reproduced in the Appendix, was heralded as an important milestone in the efforts to upgrade the quality of financial management in the Government. In the hearings on this bill:

> . . . the Comptroller General and the Director of the Bureau of the Budget strongly endorsed the proposed legislation in their testimony and urged its speedy enactment. They indicated that improved financial administration could not be accomplished soley by legislation, but that the proposed bill would be helpful in establishing Congressional policy, and in creating a framework for more rapid progress in Government-wide improvement efforts. The Secretary of the Treasury submitted a letter that indicated his complete support of the objectives of the Commission's recommendations, and pointed out that the bill would enable agencies to move forward in a vigorous improvement program.[1]

All of the major Hoover Commission recommendations relating to budgeting and accounting[2] were enacted into law except the recommendation for appropriations on the basis of annual accrued expenditures. Briefly, Public Law 84-863, imposed the following requirements:

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[1]U.S. Executive Office of the President, Bureau of the Budget, Improvement of Financial Management in the Federal Government, October 1956 (Washington: Government Printing Office, 1956), p. 5.

[2]Supra., p. 28.

1. that agency accounting systems be converted to the accrual basis of accounting in accordance with principles and standards set by the Comptroller General;

2. that adequate monetary property accounting records be incorporated into the accounting systems;

3. that appropriation requests be developed from cost-based budgets in such manner and when determined by the President, with justification by information on program costs and accomplishments;

4. that cost-based budgets be utilized for internal agency administration and operations, and for allotting of fund authorizations;

5. that consistent budget and accounting classifications be developed in line with organizational structures;

6. that each operating unit be financed from not more than one administrative subdivision for each appropriation or fund affecting the unit.

The concepts of cost-based budgeting and accrual accounting, along with the related improvements listed above, were thus given a basis of law. However, the Hoover Commission recommendation that appropriations be made in terms of annual accrued expenditures was not enacted. The bill as originally introduced contained a provision for this feature, but it encountered stiff opposition, particularly from the Committee on Appropriations of the House of Representatives.[1] Opposition to the accrued

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[1]U.S. Congress, Senate, Committee on Government Operations, Financial Management in the Federal Government, 87th Cong., 1st Sess., February 13, 1961 (Washington: Government Printing Office, 1961), p. 93.

expenditure basis for appropriations centered principally on the fact that it would necessitate granting of contract authority for long lead-time capital procurement programs which extended beyond the budget year. The House Committee objected to use of contract authority on the grounds that it weakened Congressional control and would defeat the very objective sought by the accrued expenditure provision, i.e., to strengthen Congressional control of "the purse strings." Although attempts were made in the Senate to restore the accrued expenditure provision, they were unsuccessful. Public Law 84-863 was enacted without this feature.[1]

Support for the recommendation to convert to the accrued expenditure type appropriations did not wither, however, and the President in signing Public Law 84-863 stated:

> This new legislation represents a major step forward toward a better budgeting and accounting system throughout the Government. Its enactment was recommended by the Commission on Organization of the Executive Branch of the Government. As originally introduced, however, the bill would have provided for adoption of the accrued expenditure appropriation procedure. Such a provision in law would be highly desirable and would have many benefits both for the legislative and executive branches.
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> I shall recommend to the next Congress that further consideration be given to the enactment of legislation which will permit the use of accrued expenditure appropriations whenever such procedure is considered appropriate in relation to the improved budget and accounting systems developed under the new law.[2]

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[1] *Ibid.*, p. 94.

[2] Bureau of the Budget, *op. cit.*, p. 40.

The Accrued Expenditures Controversy

The accrued expenditures appropriation concept came up for debate again early in the 85th Congress. Supporters of the proposal argued that its adoption would give Congress greater control over Government expenditures. Under the existing appropriation system, Congress grants obligational authorization to the executive agencies which includes authority for the expenditure of funds, but does not fix the year in which the expenditures are to be made. For the annual operating type appropriations, the time-lag between obligation and expenditure is usually not significant, but in the case of the continuing no-year appropriations for procurement or construction of capital-type assets, there may be delays of two, three, or even more years between the grant of obligational authority and the actual expenditure of funds. Therefore, in considering the proposed Federal Budget for a fiscal year, Congress does not begin from a zero base of expenditures, they are already committed to a significant level of expenditures under prior year authorizations, and no further Congressional authority is needed for expenditure under these carry-over funds. As a result, critics of the obligation basis of appropriations contended that ". . . Congress has no control over the amount of money spent in any one year. Moreover, there is no real review of such unexpended appropriations by the Bureau of the Budget or by the Congress."[1] Under the concept of

[1]MacNeil and Metz, op. cit., p. 56.

appropriations in terms of annual accrued expenditures, it was envisioned that the executive agencies would rejustify all of their programs to the Congress each year in order to obtain authority for the accrued expenditures estimated for the budget year. There would be an annual review by Congress of the continuing type programs for major procurement, production, or construction and an opportunity for a reappraisal of such programs in the light of current conditions. It should be noted that Congress has the power and the wherewithal under the obligation basis of appropriations to review, modify, cutback, or even cancel programs authorized in prior years, but there is no requirement that Congress ever reconsider a program once authorized. The annual accrued expenditures appropriation concept would have automatically returned all continuing programs for an annual reappraisal incident to the agencies' justification and request for accrued expenditure authorization, and Congress would be required to take positive action with respect to such programs.

Another advantage advanced in favor of the accrued expenditures concept was that it would enable Congress to exert greater control over the problem of "balancing the budget." In recommending enactment of the proposal, the Comptroller General stated:

> . . . The annual budget surplus or deficit is determined on the basis of expenditures. Placing appropriations on the annual accrued expenditure basis is, in our opinion, a practical approach to a direct correlation between annual appropriations and expenditures . . .[1]

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[1]Senate Committee on Government Operations, op. cit., p. 106.

It should not be inferred from this statement that accrued expenditures are synonymous with expenditures as reflected in the Federal Budget. Accrued expenditures represent goods and services received during a particular time frame. Expenditures, on the other hand, generally represent payments. However, since the payment stage of a transaction normally closely follows the receipt of material or services, there would be some correlation between accrued expenditures and expenditures for a period, certainly a closer relationship than exists between obligations and expenditures. Hence, it was argued that control over annual accrued expenditures would give Congress a stronger role in setting the level of expenditures and in projecting the overall budget surplus or deficit for a fiscal year.

Opponents of the accrued expenditures appropriation concept challenged the alleged benefits, particularly the claim that Congress would gain greater control. Recognizing that appropriations on the accrued expenditures basis would necessitate the granting of contractual authority in lieu of obligational authority for long lead-time procurements, the question was raised as to whether any real advantage would result. As Harvey said, ". . . Contract authority, to be effective, must include all of the elements now included in an appropriation except the one step of making funds available for payment."[1] Technically,

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[1]George Y. Harvey, "Contract Authorization in Federal Budget Procedure, "Public Administration Review, XVII, (Spring 1957), p. 118.

contract authorization would permit the negotiation and signing of contracts but would not permit payments under such contracts until expenditure authority was granted by appropriation. There is little meaning to this technical distinction, however, since the granting of authority to engage the Government in legal and binding contracts carries with it the tacit commitment to provide the funds to liquidate legal obligations arising thereunder. "The failure of Congress to make appropriations for the liquidation of contracts entered into pursuant to such authority would only result in deficiency requests and ultimately, if monies were not appropriated, in court judgments."[1] Hence, it was argued that the necessity to utilize the contractual authority device would result in no real solution to the problem of carry-over funds.

The desirability of vesting rigid expenditure control in the province of the Congress was also attacked by those who disputed the merits of accrued expenditures appropriations. Although posing no significant problem for annual operating type programs where obligations and expenditures are closely related, the imposition of inflexible expenditure limits for long lead-time programs would interpose serious difficulties in their administration. Completion of long-term contracts is influenced by many factors such as the level of contractor performance, availability of material, work stoppages, and technological

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[1] Ibid.

progress resulting in changes to contract specifications. Efficient administration of such contracts requires a degree of flexibility in the timing of expenditures. ". . . Ideally, expenditures against contracts should unfold at the most efficient rate of production of the end item and should not be subject to a particular expenditure control under the budget unless one is prepared to sacrifice efficiency control . . ."[1] Rigid Congressional expenditure controls would directly influence the scheduling of work under contract, and any disruption of the work processes because of a stretchout of expenditures caused by inflexible spending schedules could produce uneconomical results in terms of cost to the government. On this point Chermak said:

> . . . In regard to major procurement, the only way that the government can control cash expenditures is to cut back or slow down or cancel orders consistent with a maximum ceiling for cash disbursement. Under such circumstances contractors will demand higher prices than they would under firm obligations which would permit them to unfold at the most efficient rate of production.[2]

The House Committee on Appropriations was especially adamant in opposing the idea of appropriations in terms of annual accrued expenditures. Their negative position was of particular significance because of the key position of this Committee in the appropriation process, and as later developments disclosed, the ultimate fate of the concept rested in their hands. In

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[1]Lawrence E. Chermak, "Annual Accrued Expenditures," The Armed Forces Comptroller, III (June 1958), p. 13.

[2]*Ibid*. p. 13-14.

taking the position that the accrued expenditure appropriation method should not be adopted, the House Committee reported:

> . . . It has disadvantages and offers no improvement. This is not to infer that present methods and processes are perfect or the best. There may be a better way to present and process the Federal budget. The best system that can be devised ought to be employed, but the proposed accrued-expenditure method is not it.[1]

Public Law 85-759

Under the original version of the accrued expenditures legislation, the obligation basis of appropriations would have been abandoned and, instead, Congress would grant (1) contract authority for placing contracts and orders for long-lead time procurement or construction of capital type assets, and (2) accrued expenditure authority for the estimated cost of goods and services to be received during the budget year (including accrued expenditures under long-lead time programs for which contract authority was granted in prior years). This type of appropriation would have instituted congressional control over receipt of goods and services (accrued expenditures) rather than the placing of contracts and orders (obligations).

However, the original version was not enacted. Instead, an amended bill was passed that retained the obligation basis of appropriations but authorized the imposition of limitations on annual accrued expenditures.

The key provision of Public Law 85-759 approved August 25, 1958, amended section 201 of the Budget and Accounting Act of 1921 to provide, in part:

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[1]Senate Committee on Government Operations, <u>op</u>. <u>cit</u>., p. 100.

> Whenever the President determines that there has been established a satisfactory system of accrual accounting for an appropriation or fund account, each proposed appropriation thereafter transmitted to the Congress for such account pursuant to the provisions of this Act shall be accompanied by a proposed limitation on annual accrued expenditures.

The Act specifically provided that the authority for use of accrued expenditure limitations would not change the method of making appropriations in terms obligational authority. Also, any proposed limitation on annual accrued expenditures would not take effect unless incorporated into an agency's appropriation by Congress.[1]

Public Law 85-759 further included a provision that the Act would expire on April 1, 1962. It is interesting to note that the fate of the law thereby depended principally upon its acceptance by the House Committee on Appropriations, since its life was of limited duration and no accrued expenditure limitation would become effective unless enacted through the Congressional appropriations channels.

In the fiscal year 1960 budget submitted to Congress, proposed accrued expenditure limitations were included for six appropriations. The House Committee on Appropriations, in reporting the 1960 appropriation bills omitted all of the six limitations, expressing the opinion that ". . . the facts are conclusive that this proposition is an absurdity and would not save any money, and the Committee has acted accordingly."[2] The

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[1]*Ibid.*, p. 105. [2]*Ibid.*, p. 109.

reaction of the committee was to spell doom for the accrued expenditures concept. In the fiscal year 1961 budget submission, another attempt was made by the administration to incorporate accrued expenditure limitations, this time for twelve appropriations. Again, the House Committee on appropriations failed to include the recommended limitations in the appropriations bills.[1] In view of the committee's unswerving resistance, no further efforts were made to implement the provisions of Public Law 85-759, and the law expired by its own terms, ". . . it came to a quiet and unnoticed death April 1, 1962."[2]

What effect did the demise of Public Law 85-759 have on the accrual accounting concept? It removed one of the reasons for the use of accrual accounting systems, but not the major reason. Had the accrued expenditures limitation proposal been implemented with the support and advocation of the Appropriations Committees, there would have been a more impelling need for installation of accrual systems. However, elimination of the accrued expenditures limitation legislation does not imply a corresponding elimination of the accrual accounting requirements. ". . . Accrual accounting can show the effects of receiving and using goods and services without, at the same time, injecting the

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[1]Ibid., p. 110.

[2]W. Russell Roane, "Thoughts on Controlling Federal Expenditures," The Armed Forces Comptroller, VIII (March 1963), p. 31.

complexities of this mechanism [accrued expenditure limitations] into the mechanism of fund control . . ."[1] The cost-based budget requirement of Public Law 84-863 remains in force along with its counterpart, accrual accounting, and the passing of the separate, although somewhat related concept of annual accrued expenditure limitations did not diminish their utility.

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[1]Chermak, op. cit., p. 12.

CHAPTER IV

ACCRUAL ACCOUNTING IN THE FEDERAL GOVERNMENT

To develop a deeper understanding of the accrual accounting concept as applied in the Federal Government, this chapter reviews its implementation and examines more closely some of its characteristics and their meaning for government management. Then follows a resume of the progress that has been made on a government-wide basis in putting the accrual accounting concept into use.

Bureau of the Budget Bulletin 57-5

An early and major step for implementing the accrual accounting, cost-based budgeting, and related financial management reforms of Public Law 84-863 was the publication on October 10, 1956 of Bulletin No. 57-5 by the Bureau of the Budget. Addressed to the heads of all executive branch agencies, this bulletin advised that the President had placed responsibility on the Bureau of the Budget for leadership in developing a program for improved financial management in the executive branch, stipulating that intensified efforts were required on the part of the executive agencies to achieve more rapidly the desirable improvements. Initial guidelines and objectives of the improvement program were provided with the bulletin and each agency

was directed to develop a planned program to achieve the objectives. Recognizing that the nature of the reforms would require fundamental and widespread changes in agency accounting and budgeting systems and procedures, the program specified no deadline for its completion but required development of a time phased plan for attainment of the objectives, if necessary over a considerable period of time.[1]

At the heart of the financial management improvement program launched by Bulletin No. 57-5 is the objective of developing integrated agency budgeting and accounting systems. Under the program, ". . . emphasis has been given to integrating accounting and budgeting into a single management system that is based on costs coupled with simplified fund controls, and uses common classifications for programming, budgeting, accounting, and reporting."[2] The principle actions prescribed by the program are those stemming from the requirements of Public Law 84-863, namely:

1. adoption of the accrual basis of accounting, including monetary property records;

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[1]U.S. Executive Office of the President, Bureau of the Budget, Bulletin No. 57-5, Improvement of Financial Management, October 10, 1956.

[2]U.S. Secretary of the Treasury, Director of the Bureau of the Budget, Comptroller General, Improvement of Financial Management in the United States Government, Progress 1948-1963, December 19, 1963. (Washington: Government Printing Office, 1964), p. 12.

2. development of cost-based budgets with program cost information for appropriation justification, for budget execution, and for internal management;

3. use of consistent budget and accounting classifications, matched to organizational responsibilities;

4. simplification of the allotment structure.

Before turning to the subject of accrual accounting in the Federal Government, it would seem advantageous to first examine the nature of cost-based budgeting, since one of the principle purposes underlying the adoption of accrual accounting is the objective of converting the Government's budget system to one based on costs.

The Nature of Cost-Based Budgeting

As described by the Bureau of the Budget:

> . . . a cost-based budget relates accomplishments and future work plans to costs in terms of resources consumed, work in place, or, in the case of a procurement program, items procured or produced. Such a budget also identifies the resources on hand which are available for application to the program financed by the appropriation, the value of goods and services that have been ordered but have not been received, and the total obligations required to finance the program.[1]

Simply stated, a cost-based budget is one that is expressed in terms of the cost of goods and services used or consumed during the period in question, focusing attention on the actual cost of work or functions, irrespective of when

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[1]U.S. Executive Office of the President, Bureau of the Budget, Improvement of Financial Management in the Federal Government, October 1956, (Washington: Government Printing Office, 1956), p. 9.

the goods or services are ordered, received, or paid for. This is in contrast to a "cash budget" which is expressed in terms of receipts and payments of funds, and an "obligation-based budget" which focuses on the value of goods or services ordered during a period, without distinguishing between resources used and those which have not yet been received or consumed.

In actuality, costs cannot be defined simply as goods or services used or consumed, since they vary according to the type of program under consideration. For example, under a procurement program, cost refers to the value of the end items of equipment purchased, under research or construction programs, the cost of performing the projects. Bureau of the Budget Circular No. A-11 defines costs for budget use as follows:

> . . . For operating programs, costs will represent the value of resources consumed or used. For procurement and manufacturing programs, costs will represent the value of material received or produced. For capital outlay programs, costs for public works will cover the value of work put in place and costs for loan activities will represent assets acquired. In the case of appropriations for programs which are essentially operating in nature, equipment will be included in costs when it is acquired (or when withdrawn from supply inventories and placed into use); if depreciation costs are provided in the accounting system, such costs will also be included in the program and financing schedules, and appropriate deductions made to avoid duplication in the schedule totals . . .[1]

The value to management of budgeting in terms of costs instead of obligations was expressed by the former Deputy Comptroller (Accounting) of the Department of Defense:

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[1]U.S. Executive Office of the President, Bureau of the Budget, Instructions for the Preparation and Submission of Annual Budget Estimates, Circular No. A-11, Sec. 14., August, 1961.

> For management purposes, the ultimate financial measurements of performance of a program should be related to the ultimate physical measurements of performance - that is, they should be expressed in actual expenses of operation and maintenance, costs of equipments actually received, cost of construction work in place, cost of actual research and development work accomplished, all compared with the budget estimates of cost for such performance. Obligations incurred, to the extent they differ from costs, measure only progress in placing contracts and in legally making an appropriated fund unavailable for other use (often on the basis of tentative estimates) - these measurements have more limited significance of the programmed work or acquisition of property.[1]

Installation of a cost-based budget system in an agency does not, however, eliminate the need for obligation controls. The appropriation system remains on the basis of obligational authority and budgets must therefor provide funding data in terms of obligations. Costs must be reconciled to obligations by adjustment of the cost figures to eliminate unfunded costs such as property or services received without charge, depreciation or other costs not requiring funding, and by reflecting the net increase or decrease in resources and liabilities carried forward from year to year such as inventories, advance payments, and unpaid undelivered orders. The fact that appropriations are stated in terms of obligational authority does not, however, lessen the utility of costs in budget formulation or administration. In the words of an official of the Bureau of the Budget:

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[1]Howard W. Bordner, "Structure of Accounts for Appropriated Funds," The Federal Accountant, XII (June 1963), pp. 76-77.

> We look upon costs as the best financial measure of performance. However, as I think you know, the cost basis of budget presentation does not exclude the presentation of data on obligations; a cost-based budget as we know it reflects costs for each activity or program, the change in selected resources already financed by the appropriation from the beginning of the year to the end of the year, and the total obligations being incurred under the appropriation. Congressional control remains on an obligation basis, while at the same time we get the advantages of having performance data on a cost basis, readily comparable with quantities of work performed.[1]

In short, it can be concluded that the fundamental purpose of cost-based budgeting is to accentuate cost measurements in Government management.

The Nature of Accrual Accounting in the Government

The underlying concept for accrual accounting in the Federal Government is fundamentally similar to that found in the commercial world, insofar as recording revenues in the period earned and expenses in the period incurred. However, unlike private industry, and except for certain commercial-type government operations, the purpose for accrual accounting in government is not to match revenue and expense for an accounting period. Rather, the objective served by accrual accounting in the Federal Government is the production of more meaningful accounting reports to promote effective management planning and control. Cost information becomes the central gauge. As stated in the accounting principles and standards issued by the Comptroller General:

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[1]William F. McCandless, "Ten Years of Progress," The Armed Forces Comptroller, V (March 1960), p. 8.

> . . . To be of greatest usefulness, the accounting records and financial reports should disclose the resources available for the conduct of operations, and the cost of the resources consumed in performing the work during the period. The cost of the work done may be compared with previously approved budgets, and may be related to the value or benefits of the accomplishments. Costs also provide comparable financial terms for the appraisal of alternative means of doing a particular job or performing a function.
>
> Accrual accounting permits the development of costs, which, in contrast to obligations and disbursements, are a realistic financial measurement of the resources actually consumed in doing the work. Under the accrual method, as operating transactions occur the related financial transactions are recorded, including the recording of property in the period in which received. As a result, reports prepared from these accounting records disclose in financial terms the operating events which occurred during the period.[1]

As indicated earlier, adoption of the accrual basis of accounting does not eliminate the requirement for obligation accounting. Appropriations are still in terms of obligational authority and fund controls must still be exercised over obligations incurred. Control over obligations is, in fact, a legal necessity in order:

> . . . to comply with the specific requirements and limitations of such laws as R.S. 3679 (the Antideficiency Act). One of the principle purposes of this act is to prevent the incurring of obligations or the making of expenditures in such a way as to create deficiencies in appropriations and to fix responsibility within an agency for excess obligations or expenditures.[2]

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[1]U.S. General Accounting Office, Policy and Procedures Manual for Guidance of Federal Agencies (Washington: Government Printing Office, 1957), par. 1282.30.

[2]U.S. General Accounting Office, Illustrative Accounting Procedures for Federal Agencies, 1962 (Washington: Government Printing Office, 1962), p. 2.

While there remains the need for control over obligations and expenditures under an accrual accounting system, the principles and standards for such systems, as prescribed by the Comptroller General, provide that costs play the predominant role. ". . . obligations continue to be recorded in the period in which goods and services are ordered, regardless of when received, paid for, or used, but not in the detail that the costs are recorded . . ."[1] ". . . The emphasis should be on costs, which can be kept in such detail as necessary and on operating budgets based on all resources to be used . . ."[2]

Under the accrual system, revenues enter the accounting records in the period in which they are earned even though collection may be accomplished in a later period. Receipts of materials and services are recorded as accrued expenditures in the period in which they are received, and expenses of the period represent the cost of materials and services actually consumed in the performance of operations. The relationship of the various stages of a transaction under the accrual system can be illustrated as follows:[3]

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[1]U.S. General Accounting Office, Policy and Procedures Manual for Guidance of Federal Agencies (Washington: Government Printing Office, 1957), par. 1282.30.

[2]*Ibid.*, par. 2020.60.

[3]*Ibid.*, par. 2020.50.

1. Placing a contract or purchase order for goods or services - recorded as an obligation in the period in which the contract or order is placed.

2. Receipt of the goods or services - recorded as an accrued expenditure in the period when received.

3. Goods and services applied or consumed - recorded as an expense or cost of work in place for the period.

4. Payment made - recorded as a disbursement in the period when paid.

In contrast, under the obligation basis of accounting, recording of data is restricted to the obligation and disbursement stages, and it is readily apparent that the information derived from such a system is of limited value in comparison with that available under the accrual basis. This is so because, in comparison to the traditional obligation basis of accounting:

> . . . an accrual accounting system provides additional and more useful information, since it reflects not only the availability of funds, but also furnishes data on resources on hand in an agency, and the actual use of such available resources. Cost data on the use of resources are essential to agency management . . .[1]

Stated another way:

> . . . obligation records alone seldom provide much in the way of cost data that can be matched against performance to measure operating efficiency. The incurrence of obligations does not always coincide with the acquisition of assets, the incurrence of

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[1]U.S. Executive Office of the President, Bureau of the Budget, Improvement of Financial Management in the Federal Government, October 1956, p. 7.

> actual liabilities, or the use of resources in the performance of operations - all of which are significant stages in the management of agency activities.[1]

An accrual system thus expands beyond the scope of obligation and expenditure accounting and requires:

> . . . a full control of all resources used during the accounting period designated. Use of all resources including cash must be reflected on the accounts for the period in order that the costs for work produced during the period may be obtained. Use of all resources rather than obligation or expenditure becomes the event which triggers the accounting record.[2]

Accrual Accounting and Management Control

An important purpose served by accrual type accounting systems is the greater control provided over the financial aspects of an agency's operations and its resources. In comparison with systems based only on obligations and expenditures, accrual accounting affords far greater control over assets, liabilities, revenues and expenses of an agency. The accrual basis requires capitalization of assets which are not applied to current period operations and exercise of accounting control over such resources until they are consumed. Inventory accounts, for example, are employed for control over materials and supplies in stock which will be consumed in subsequent accounting periods. Under a fully developed accrual system, fixed assets, too, are placed under accounting control and, where it serves a useful

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[1]Edwin J.B. Lewis, "Financial Management in the Federal Government," The Federal Accountant, XII (June 1963), pp. 58-59.

[2]Laurence E. Chermak, "Fitting Accounting Technique to Purpose," Public Administration Review, XIX (Summer, 1959), p. 176.

purpose, incremental charges are made in the periods benefiting from their use through depreciation accounting techniques. Control over liabilities is another feature of accrual accounting not found in the obligation accounting system. The obligation basis jumps from the obligation stage to the expenditure stage, without recording the intervening steps in the transaction. The accrual basis, in contrast, requires establishment of a liability in the accounts at the time materials and services are received. Liabilities incurred are thereby revealed and their appearance in the accounting records forms a basis for their control.

Control over revenues under the accrual basis begins at the time revenues are earned by establishment of accounts receivable. This is in contrast to the cash basis of accounting that recognizes income only at the time it is collected. Recognition of receivables under accrual accounting not only affords a basis for complete and accurate statements of financial results of operations, it also permits the maintenance of adequate follow-up controls to insure that revenues are actually collected.

By far the most important benefit to be derived from accrual accounting in Government is the greater control it affords over costs. Control over costs is of predominent importance in most Agencies of the Federal Government since the nature of most agency operations requires emphasis on the use of funds provided for pursuance of its programs, with only minimum occupation on revenue producing activities. Costs are obviously

more meaningful for management emphasis than obligations or expenditures, since costs represent the use or commitment of resources towards the accomplishment of some purpose. Accrual accounting is a prerequisite of a valid cost accounting system for, to insure development of accurate cost information, the accounting records must reveal the true status of assets, liabilities, and expenses and show fully the cost of resources consumed or applied during the accounting period. Cost accounting is a logical extension of the accrual basis of accounting, and as Mikesell and Hay have written:

> . . . Cost accounting is virtually indispensable in any scheme or plan to judge the efficiency of government. Comparisons based upon generalities may be not only erroneous but even misleading. In addition to its use in determining efficiency, and possibly more important, cost accounting is a tool for promoting it . . . [1]

The superiority of management based on costs coupled with performance data is evident from the following statement by Robert Anthony:

> . . . Cost information is needed both as a guide to operating executives in making decisions and as a means of comparing accomplishments with the resources consumed in doing the work. Cost incurred is the only valid measure of resources consumed for a specified job in a specified period of time. Obligations measure purchase orders placed; accrued expenditures measure resources received; expenditures measure bills paid - but costs measure consumption . . . accomplishments and costs must be considered together in a judgement of performance. Unless there is a

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[1]R. M. Mikesell and Leon E. Hay, <u>Governmental Accounting</u> (Homewood, Illinois: Richard D. Irwin, 1961), p. 7.

> matching of what was done with the cost of doing it, there is no way in the world of making an informed judgment about how well the operation was managed.[1]

Government-Wide Progress in Establishing Accrual Accounting Systems

Almost eight years have passed since enactment of Public Law 84-863 which set the legislative requirements for accrual accounting and cost budgeting. A recent report reviewing the work of the Joint Financial Management Improvement Program stated:

> There are two major areas in which progress has not been adequate nor as rapid as it should be. These involve establishing accrual accounting systems that are tailored to the needs of the agency and are in keeping with prescribed principles and standards, and making effective use of cost information for the purposes of internal agency management.[2]

The report further advised that, as of the close of fiscal year 1963, of the 133 civilian agency accounting systems that were subject to approval by the Comptroller General, 46 complete systems and parts of 15 additional systems had been approved. In the Department of Defense, the only approved complete system is that covering the civil functions of the Army Corps of Engineers. In addition, nine other Defense systems were approved in part, covering areas such as pay and collection procedures.[3]

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[1] Robert N. Anthony, "New Frontiers in Defense Financial Management," The Federal Accountant, XI (June, 1962), p. 20.

[2] U.S. Secretary of the Treasury, Director of the Bureau of the Budget, Comptroller General, Improvement of Financial Management in the United States Government, Progress 1948-1963, December 19, 1963, (Washington: Government Printing Office, 1964), p. 3.

[3] Ibid., p. 27.

Even these figures are deceptive, however, for as the report goes on to state:

> . . . most systems approved the last 15 years need reexamination and updating in the light of current requirements. For example, some of the approved systems do not incorporate accrual accounting to the extent contemplated by Public Law 84-863, approved in August 1956. Therefore, while 46 complete systems have been approved by the Comptroller General as adequate in the light of legislation and conditions as they existed at the time of approval, this does not necessarily reflect the number that would be deemed adequate when measured against current requirements.[1]

There has, in fact, been evidence of a lack of harmony within Government accounting circles as to just how far the accrual accounting objective is intended to be carried,". . . not all agency accountants understand the objectives and procedures involved. Nor is there common agreement that utilization of accrual accounting will always produce substantially improved results."[2] Even where accrual systems have been installed, they have, in many cases, failed to meet the requirements for approval. During fiscal year 1963, for example, ". . . 15 complete systems submitted to the General Accounting Office for review or approval had to be returned to the agencies because they did not meet current requirements."[3] The principle deficiencies reported

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[1]Ibid.

[2]Federal Government Accountants Association, "Accounting Principles and Standards," Special Report, The Federal Accountant, XII (December 1962), p. 132.

[3]Secretary of the Treasury, Director of the Bureau of the Budget, Comptroller General, op. cit., p. 27.

were: (1) failure of the system truly to employ costs as the yardstick in budgeting and internal management, and (2) conversion of obligation and expenditure data to accrual information at annual intervals only.[1]

Further evidence that only limited progress has been made in achieving the objectives of Public Law 84-863 can be drawn from the report that, in the last five years, only six complete accounting systems have been approved under the standards of the Comptroller General and, as yet, none of the major departments have received approval for all of their accounting systems. Furthermore, while most of the civilian agencies are presenting their appropriation requests in the cost-based budget format, many still use obligation instead of cost data as the basis for day-to-day management of operations.[2]

The General Accounting Office took action early in fiscal year 1963 to clarify and strengthen the instructions and guidance regarding accrual accounting. The accounting principles and standards were revised ". . . to remove any implication that use of the accrual basis is discretionary."[3] The revisions clearly stipulate that, although there is room for variation in the techniques of accrual accounting according to the needs and

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[1]Ibid. [2]Ibid., p. 3.

[3]U.S. Secretary of the Treasury, Director of the Bureau of the Budget, Comptroller General, The Joint Financial Management Improvement Program, Annual Report Fiscal Year 1962, November 21, 1962. (Washington: Government Printing Office, 1962), p. 6.

preference of the individual agencies, there is no option insofar as adoption of an accrual system is concerned. Specifically, the revised principles provide:

> . . . The maintenance of accounts on an accrual basis is a basic requirement for all executive agencies. The techniques of applying the accrual basis may vary from agency to agency and between the different components of an agency in accordance with the circumstances involved.[1]

Regarding the frequency of converting data to the accrual basis, the revised principles state:

> One method is to record expenditure transactions currently on the accrual basis as goods and services are received or as soon thereafter as the necessary information is available. An alternative technique is to record expenditure transactions initially on a cash basis and record accruals only at the end of the period for liabilities incurred but not paid. The minimum requirement for converting recorded cash disbursement data to an accrual basis is that such conversions should be made monthly. Conversion at less frequent intervals would generally not provide information sufficiently current to be useful to agency officials in managing operations . . .[2]

Thus, it is clear that, although there is flexibility regarding the accounting methods to be employed, there is a firm requirement that the executive agencies adopt the accrual basis. It is well founded in law and in the principles and standards prescribed by the Comptroller General. Although some progress has been made toward the goal of converting the Government's accounts to the accrual basis, it is obvious from the current government-wide status that much remains to be done.

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[1]U.S. General Accounting Office, Policy and Procedures Manual for Guidance of Federal Agencies (Washington: Government Printing Office, 1957), par. 1282.50.

[2]Ibid.

CHAPTER V

ACCOUNTING IMPROVEMENTS IN THE NAVY

In dealing with the subject of Navy accounting, no attempt will be made to describe the mechanics of the various systems employed since the scope of such a presentation, the numerous details, and the complexities involved render such a treatment too broad. The approach here is limited to a concise description of the role of accounting in the Navy, a brief coverage of some accrual applications that exist, the fund accounting improvements that have been installed in recent years, and the influences on accounting stemming from the Department of Defense.

Role of Navy Accounting

In general terms, the purpose served by the Navy's accounting and reporting systems is:

> . . . to control and disclose, as required by law and regulations, the acquisition, use, and disposal of public resources and to provide systematically to the manager, timely, accurate, financial and nonfinancial intelligence required for planning, programming, budgeting, and appraisal, and for management of functional areas.[1]

The role of accounting can, therefore, be dichotomized

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[1]U.S. Department of the Navy, Financial Management Study, NAVEXOS P2426B-7, 26 October 1962 (Washington: Government Printing Office, 1963), p. 83.

into two broad areas: (1) internal uses of a general management nature, and (2) external demands to show compliance with legal requirements and to render an accounting of stewardship. This can be viewed as parallel to the purposes served by management accounting and financial accounting in private industry.[1] The principle external demands are those imposed by the Congress, the General Accounting Office, the Bureau of the Budget, the Treasury Department, and the Department of Defense. Internal management requirements stem from the needs of the management bureaus and offices of the Navy Department, the field activities or operating units, plus any intervening levels of management, if such exist.

The principle types of accounting performed in the Navy are: (1) fund accounting for control of appropriations, funds, and their subdivisions; (2) capital property accounting for control of shore station plant property, minor property, ships, aircraft, and missiles; (3) payroll accounting for military personnel and civilian employees; (4) inventory accounting for material held in stores accounts; and (5) cost accounting for analysis of expenditures for various purposes. Program accounting under the Department of Defense programming system is an additional area of accounting effort that has yet to be fully integrated with the Navy's accounting system.[2]

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[1] Supra., p. 7.

[2] U.S. Department of the Navy, Office of the Comptroller, Accounting Processes, 1 July 1962, p. 1.

The three major purposes served by Navy accounting are:

> 1. To report the use of funds under the various appropriations granted to the Navy by the Congress . . .
> . . . .
> 2. To control the obligation and expenditure of funds and thus to prevent their exceeding the limitations imposed by the Congress, established by fund administrators at various levels, or subdivisions of funds granted to program administrators, including operating commands, and shore activities . . .
> . . . .
> 3. To provide analyses of the costs of maintenance and operation, construction, and procurement . . .[1]

The first two purposes cited above can be considered as the fund control function, while the third purpose is the managerial accounting function, involving cost accounting techniques designed to relate output or performance with the costs involved.

Briefly, the channels of fund administration in the Navy flow from the Comptroller of the Navy under delegated authority from the Secretary of the Navy, to the various bureaus and offices of the Navy Department to which the appropriations are assigned for administration, down to the field activity, command, or operating unit level to which allotments are granted.

For fund control, there are three basic levels of accounting records in the Navy:[2]

1. The appropriation level, comprised of the Master Control Accounts and the Appropriation Cash Accounts maintained

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[1] U.S. Department of the Navy, Financial Management in the Navy, NAVPERS 10792-A, 23 March 1962, pp. 142-144.

[2] *Ibid.*, pp. 116-155.

under the direction of the Comptroller of the Navy. This is the Navy's highest level of accounts, in summary form. Reports to the Treasury Department and the General Accounting Office flow from these records.

2. The allocation level, comprised of the control ledgers maintained by the bureaus of the Navy Department for control of funds by appropriation, budget activity, and budget project accounts. Control over the field accounting system stems from this middle level of bureau accounts.

3. The allotment or suballotment level, comprised of the fund resource ledgers maintained at the lowest level of fund administration. A separate ledger is kept for each allotment or suballotment, recording status in terms of commitments, obligations and expenditures.

The fund accounting system is designed primarily for the function of regulating the commitment, obligation, and expenditure of fund authorizations. Insofar as appropriated funds are concerned:

". . . The primary emphasis of all Navy accounting is placed on obligation accounting as a medium of control . . ."[1]

Cost accounting is employed in various ways and to varying degrees in the Navy's accounting systems according to particular management needs. The basic structure for general cost accounting is the expenditure account series, which forms an

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[1]U.S. Department of the Navy, Financial Management Study, NAVEXOS P2426B-7, 26 October 1962, p. E-4.

element in classification of all accounting transactions. From the same basic accounting documents used for fund accounting, data is compiled according to expenditure account classifications for analytical purposes. The degree of refinement of the various cost accounting systems in use depends primarily on the nature of the activity involved. For the industrial-commercial type activities which operate under the Navy Industrial Fund and the accrual basis of accounting,[1] custom designed cost accounting systems are employed, in some cases on the standard-cost method, and overhead costs are allocated to production work. Modified industrial activities, which operate under appropriated funds, also utilize cost accounting extensively and also distribute overhead to production orders. Nonindustrial activities generally do not allocate overhead.[2]

There are also certain specialized cost accounting programs used by the Navy for specific purposes. The facilities maintenance cost accounting system, employed in conjunction with the public works department maintenance control program, provides cost data related to types of facilities for use in analysis and setting of maintenance cost standards. The equipment maintenance cost accounting system provides cost data for management use in the maintenance and operation of automotive type equipment. There is also a utilities cost accounting system

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[1]*Infra*, p. 65.

[2]Office of the Comptroller, *op. cit.*, p. 16.

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[1] _Infra_, p. 65.

[2] Office of the Comptroller, _op. cit._, p. 16.

for control over the cost of producing and distributing utilities services and for charging users for such services.

While cost accounting techniques are used extensively in the Navy, generally and with some exceptions, accounting for appropriated funds is not on the accrual basis, hence, true costs are not developed. So long as the obligation basis of accounting is in use, accounting data is in terms of commitments, obligations and expenditures, not true costs or expenses of the period. ". . . The accrual basis of accounting is essential to the development of complete cost accounting."[1]

Applications of Accrual Accounting in the Navy

While accrual accounting is not in general use in the Navy's appropriation and fund accounting processes, it does exist in some specific applications. Its most prominent use is found in activities which are financed under the Navy Industrial Fund. The basis of industrial fund operations stems from Public Law 81-216,[2] which authorized the use of working capital funds for activities performing work of an industrial or commercial nature. Without exploring in detail the operation of the industrial fund and its accounting system, it is pertinent to recognize its objectives from a management viewpoint, some of which have been stated to be:

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[1]U.S. Department of the Navy, Financial Management in the Navy, NAVPERS 10792-A, 23 March 1962, p. 115.

[2]*Supra*., p. 23.

a. achieve lower unit costs from a production point of view;

b. facilitate the adoption of an accounting system that is coordinated with the budget structure;

c. develop a "cost-based" budget for production in terms of unit costs of end-products by elements of costs;

d. create a desire to measure production by accrued costs for a specific job in a specific period of time;

e. segregate such costs as unutilized capacity;

f. adopt standard costs with flexible budgeting for financial control at the operating level; and

g. assist management at the activity level and the bureau level in matching production accomplishments with costs accrued.[1]

To facilitate management of the industrial-commercial activities, and to produce the type of information needed to emphasize the cost of end-products or services produced, each industrial fund activity is provided with a cost accounting system which operates under the accrual accounting concept and is specially designed according to the peculiar needs of the activity. The extent of the Navy's industrial fund operations can be assessed from the fact that the value of work and services provided by Navy Industrial Fund installations during fiscal year 1963 exceeded two billion dollars and embraced the operations of sixty seven activities, including shipyards, aircraft maintenance, printing plants, the Military Sea

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[1]U.S. Department of the Navy, "Observations Concerning the Navy Industrial Fund," The Navy Comptroller Review, March 1962, pp. 21-22.

Transportation Service, public works services, ordnance plants, and research activities.[1]

Accrual accounting systems are also found in activities under the management of the Navy's Bureau of Medicine and Surgery. First installed in 1961, such systems were recently extended to all naval hospitals and medical centers.[2]

Accrual accounting procedures were recently established under the Navy Stock Fund. Effective April 1, 1964, the revised stock fund accounting system provides for incorporating the accrued expenditures stage into the accounting process in order to establish accounts payable data at the time that title to material passes to the Navy. The principle purpose of this particular extension of accrual accounting is to gain better control over Navy Stock Fund cash by generating more accurate accounts payable information.[3]

Improvements in Fund Accounting

In reviewing the progress towards accounting improvements by the Navy, it is pertinent to first recognize that many of the reforms prompted by the legislation covered in Chapter III have

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[1]U.S. Bureau of the Budget, Appendix, The Budget of the United States Government for the Fiscal Year Ending June 30, 1965 (Washington: Government Printing Office, 1964), pp. 328-329.

[2]U.S. Department of the Navy, Bureau of Medicine and Surgery letter BUMED - 462 of 10 June 1963.

[3]U.S. Department of the Navy, Office of the Comptroller, Modified System of Navy Stock Fund Accounting, NAVEXOS P-2449, December, 1963, p. 1-4.

been in effect in the Navy for some time.

In this regard:

> . . . Property accounting on both an item and dollar basis had been in existence for many years . . . Industrial or Commercial-type accounting to the extent permitted by law was also established at major activities prior to title IV. The Navy has been using a revolving stock fund to finance common usage items on an issue rather than initial procurement basis since 1893 . . .
> . . . .
> A complete cost accounting system was used by the Navy before passage of title IV . . . The Navy has, for many years, accounted for inventory property on both a quantitative and monetary basis and for plant property on both an item and dollar basis . . .[1]

However, accrual accounting and cost-based budgeting for appropriated funds have not been implemented except for the specific applications noted above. Steps have been taken in that direction since enactment of Public Law 84-863 and a number of accounting improvements have been installed. The first phase of the Navy's program for improvements in fund accounting was begun in July 1957. The principle improvements that were installed at that time were:

1. Funding was raised to the budget activity level (the first subdivision below the appropriation level). This is short of the objective of Public Law 84-863 that each activity be funded by not more than one allotment under an appropriation, however the Navy is confronted with difficulties in this regard since fund administration by the various bureaus generally begins

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[1]U.S. Department of the Navy, Financial Management in the Navy, NAVPERS 10792-A, 23 March 1962, pp. 11-13.

at the budget activity level. Hence, the budget activity is presently the highest feasible funding level.

2. Procedures for control and complete accounting for accounts receivable were installed.

3. A double entry system of accounting was prescribed for allotment accounting. This is a necessary prerequisite to an accrual accounting system.

Phase II of the improvement program was scheduled for implementation on 1 July 1959 and was designed to institute accrual accounting to the accrued expenditures stage.[1] It would not have implemented the accrual accounting concept fully, but would have laid the basic groundwork for that objective. Phase II was to apply to all appropriations and funds except the Navy Industrial Fund, and provided for modifying the Navy's fund accounting system to incorporate accounting procedures for accounts payable, accrued liabilities, and accrued expenditures. However, this phase was never implemented. Difficulties arose between the bureaus and the Navy Comptroller's office over a question of personnel ceilings and fund transfers incident to the relocation of formal obligation accounting from the Navy regional accounts offices to the bureaus, a move which was a part of the Phase II plan. Failure to resolve this dispute led to

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[1]U.S. Department of the Navy, Modified System of Accounting Phase II, NAVEXOS P-1985, 3 December 1958.

cancellation of the Phase II instructions.[1]

The next phase of the program for improvements in fund accounting was implemented on July 1, 1960, however, the scope of these changes was far below the scale of the defunct Phase II plan. The major change made at this time was to establish revised accounting procedures for manufacturing, work, and services between allotments, requiring that all such work be financed on a reimbursable basis under the operation and maintenance allotment of an activity.[2] Besides eliminating cross funding by suballotments between activities, this requirement was a step towards disclosure of the full costs of a station's operations by requiring that work performed for other activities be initially financed and accounted for under the performing station's funds, with collection of such costs from its customers. Other system refinements and report format changes were also made, but none were of major significance insofar as making progress towards accrual accounting.

Efforts were continuing during this period, however, for development of accrual accounting in the Navy. In 1959, policy guidance was issued from the Department of Defense that cost-based budgeting and accrual accounting would be installed first under the operations and maintenance appropriations. In line

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[1] Personal interview with Mr. Philip L. O'Connell, Assistant Comptroller, Accounting and Disbursing, Office of the Navy Comptroller, February 11, 1964.

[2] U.S. Department of the Navy, Improvements in Fund Accounting, NAVEXOS P-2196, 15 March 1960.

with this policy, implementing procedures and instructions were developed by the Office of the Navy Comptroller to initiate accrual accounting under the appropriations Operations and Maintenance, Navy and Operations and Maintenance, Marine Corps. However, to date these instructions have not been put into effect. For the reasons that stemmed the latest momentum towards accrual accounting, we must turn to developments at the Department of Defense level.

Implementation of Public Law 84-863 at The Department of Defense Level

The first major step by the Department of Defense towards implementing Public Law 84-863 was the promulgation on May 29, 1959 of Department of Defense Directive 7040.1 which established the Program for Improvement in Financial Management in the Area of Appropriations for Operation and Maintenance. The pattern was thus set to manage the task of revamping the budgeting and accounting methods of the military services by a series of improvement programs covering each type of appropriation separately, i.e., operations and maintenance, military construction, military pay, procurement, and research and development. Directive 7040.1 set forth the principles and policies to be followed by the military departments in developing programs for improved financial management under operations and maintenance appropriations. It required establishment of a time-phased schedule to accomplish the system improvements. Without spelling out all of the many details of this directive, the

major requirements provided that the military departments develop plans for:

1. use of cost-based budgets for appropriation requests, administration, and internal management, including administrative subdivisions of funds,

2. development of performance and program cost information for budget justification,

3. use of a consistent account structure for programming, budgeting, and accounting,

4. simplification of the allotment structure with the objective of funding each operating unit with a single allotment from each appropriation, and

5. adoption of the accrual basis of accounting with financial accounting for property.

The former Deputy Comptroller for accounting in the Defense Department, in describing the philosophy underlying Directive 7040.1, stated:

> . . . it is the objective to establish a system of financial management which will provide incentives to management at every level to achieve the greatest degree of military effectiveness with the resources available. It is believed that financial management arrangements can and should be devised in such a way that, as a result, human nature will work for this objective rather than against it.[1]

To strengthen the financial management process at the field activity or operating unit level, the program contemplated,

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[1]Howard W. Bordner, "Department of Defense Program for Improvement in Financial Management for Operations and Maintenance," The Armed Forces Comptroller, IV (June, 1959), p. 24.

as ultimate goals, financial arrangements that would:

> . . . Use an operating budget for each installation, or other operating unit, as a basis for obtaining authority to finance operations, with emphasis on costs to be incurred . . . This operating budget . . . should give the operating unit financial authority to incur costs and obligations, with only one overall absolute limitation - the total amount of the current budget . . . every item of operating cost or expense would be required to be paid for and charged to the allotment, or budget limitation . . . Within the installation there should be a part of the operating budget, with parallel accounting for costs, for each officer responsible for a segment of operations . . . Under this system the local Commander and staff would have a maximum incentive to consider costs in budgeting and program performance, especially in making day to day decisions.[1]

The program thus had the objective of reorienting the focus of budgeting and management of the operation and maintenance programs towards costs, and it required the design and installation of accrual accounting systems to produce the necessary cost information.

In 1961, the second phase of the improvement program was launched with the publication of Department of Defense Directive 7040.2, the Program for Improvement of Financial Management in the area of Appropriations for Acquisition and Construction of Military Real Property. The specifications of this program were designed to fit the requirements of the Military construction programs, but the basic objectives were parallel to those of Directive 7040.1, fundamentally to require the development of accrual accounting and cost-based budgeting, bringing costs to the forefront in the management process.

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[1] _Ibid._, pp. 24-25.

These directives, 7040.1 and 7040.2, remain in effect at the present time and have provided the stimulus for a number of accounting improvements, but their objectives are yet unattained. Directive 7040.1 originally provided that the operation and maintenance improvement program would be completely implemented by July 1, 1962, however this schedule was not attained and the directive was later modified to remove the deadline.[1] The programs remain in effect on an open-end basis, with the policies and principles serving as ultimate objectives, but without direction for compliance within a specific time frame.

As a result, although these policy directives provide for the development of accrual accounting and cost budgeting systems, the fact that they have not been implemented indicates ". . . that the Defense Department systems do not focus primarily on costs; that is, they are not built around the concept of finding out how much it costs to operate an installation or to accomplish a mission. Instead, they continue to rely on the obligation basis as the primary focus of control."[2] This is not meant to imply that costs play no role in management of the military services, for:

> . . . cost control is used in some areas - in activities operating under industrial funds, for example - and admittedly also there is a number of supplementary

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[1]Department of Defense Directive 7040.1 - CH2, July 11, 1963.

[2]Robert N. Anthony, "New Frontiers in Defense Financial Management," <u>The Federal Accountant</u>, XI (June 1962), p. 21.

> control systems that collect and use cost information. These systems are valuable, but the very fact that these are supplementary to the obligation-based controls indicates their basic weakness. When an operating executive has two different sets of controls for the same activity, he is bound to receive contradictory signals from them; and one signal must be disregarded. Whenever these contradictions arise, there can be no question that the obligation system, which is reinforced by all the implications of the Antideficiency Act, dominates management thinking and that the cost-based system plays second fiddle.[1]

Why have the Department of Defense programs for financial management improvements as prescribed in Directives 7040.1 and 7040.2 not been pursued to fruition? Their purpose is to provide a framework for financial management on the basis of costs instead of obligations and their implementation would go a long way towards the objectives of Public Law 84-863. What has impeded the progress in putting them into effect? Beyond the technical problems involved in accomplishing the widespread systems modifications involved in their implementation, a new and major influence emerged in 1961 that presaged significant changes in the financial management philosophy of the Department of Defense. This new element in the financial management structure is the programming system. Its impact on the accrual accounting and cost-based budgeting concepts are described below.

Impact of DOD Programming System

With the change of Administration in 1961, a new management team assumed control of the Department of Defense and far reaching changes in management of the military

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[1] *Ibid.*

establishment were to ensue. One of the most significant changes was the introduction of the new Department of Defense program system, the "Five Year Force Structure and Financial Program," the development of which began in 1961 under the present Department of Defense Comptroller, Mr. Charles J. Hitch. The character and functioning of the programming system will not be described in detail here, since that is a subject beyond the scope of this thesis. It will suffice to cite the underlying purpose of the programming system and the effect it has had on the accrual accounting and cost budgeting efforts.

In describing the considerations which led to development of the programming system, the Department of Defense Comptroller explained:

> . . . the Defense budget, as it had evolved since the end of World War II, was oriented essentially along functional lines [by appropriation categories] [1] . . . this functional arrangement, which permeated the entire financial management system including accounting and progress reporting, did not focus on the key decision-making areas which were of principle concern to top management in the Defense Department . . .
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> . . . .
>
> . . . the existing financial management system would have to be reoriented and restructured if it was to provide the data needed by top Defense managers to make the really crucial decisions, particularly those on the major forces and weapons systems . . .
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> . . . .
>
> . . . the entire system had to be reoriented to provide top management with essential data in terms of major military programs . . .[2]

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[1]*Supra*., p. 70.

[2]Charles J. Hitch, "Management of the Defense Dollar," *The Federal Accountant*, XI (June, 1962), pp. 33-36.

The origin of the programming system was the need for a link between planning in terms of forces and missions, and budgeting in terms of functional appropriations. The system was designed first to serve top level management and decision-making, particularly in matters involving allocation of resources among alternative programs and weapons systems. "The object of the programming study was to develop a comprehensive system for planning and controlling major programs at the highest levels within the Department of Defense . . ."[1]

The efforts devoted to the task of developing and installing the programming system were of formidable dimensions and eclipsed the accrual accounting and cost-based budgeting programs, relegating them to a secondary status. This was recognized by the former Director of the Bureau of the Budget in the following reply to the question of whether the administration was backing away from implementation of Public Law 84-863:

> . . . the introduction in the Pentagon of the program system . . . has, in effect, taken a great deal of the energy not simply of Messrs. McNamara and Gilpatrick, but also of Messrs. Hitch, Schaub and others. Granted that given only a limited number of hours in a day they may have had to defer some accounting improvement in the interests of getting the programming system started. I don't believe this represents any difference of view but simply a temporary choice of priorities . . .[2]

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[1] U.S. Department of Defense, Study Report on the Programming System for the Office of the Secretary of Defense, 25 June 1962, p. I-1.

[2] Remarks of David E. Bell at a meeting of the Washington Chapter, Federal Government Accountant's Association, May 1962, cited in The Federal Accountant, XII (September 1962), pp. 16-17.

Regarding the question of using obligation information instead of true cost data in the programming system, the Deputy Assistant Secretary of Defense (Programming) had this to say:

> . . . Our programming operations now focus primarily on total obligational authority . . . I do not think our ultimate objectives are in conflict with Public Law 84-863. Though we have not planned to incorporate cost-based budgeting into our programming operation, we do want to improve the cost estimates in program terms. The fact that we can get along faster with our new programming system if we keep to obligation and expenditure reporting should in no way impede the efforts of those who are working on cost-based budgeting.[1]

A similar position was taken by the Defense Comptroller:

> . . . the objectives that we are seeking are the same as those which underlie the concept of cost-based budgeting and accrual accounting - namely: the relating of costs to performance. The essential difference is the level at which the concept is applied. In our programming system we are trying to provide a sound basis for evaluating the cost and effectiveness of alternative weapon systems. The programs we are dealing with involve substantial outlays projected over a period of years . . .
> . . . .
> Cost-based budgeting and accrual accounting deal primarily with costs over shorter time periods and with the performance of all of the many tasks which go to make up an effective fighting machine . . . we believe first attention must be given to the accounting needs of our programming system . . . When we have satisfied this urgent need, we will be able to take another look at the problems involved in moving toward cost-based budgeting and accrual accounting.[2]

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[1]Remarks by Hugh McCullough at the Eleventh Annual National Symposium, Federal Government Accountants Association, May 1962, cited in The Federal Accountant, XII (September, 1962) p. 83.

[2]Hitch, *op. cit.*, p. 42-43.

A more recent statement by the Deputy Assistant Secretary of Defense (Accounting and Audit) further reveals the prevailing attitude towards accrual accounting at the policy level of the Defense Department:

> . . . My concept of dynamic accounting in the Department of Defense is not to extol the virtues of accrual accounting, cost accounting or even cost-based budgets, all of which have significant recognized virtues.
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> . . . .
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> . . . accrual accounting and cost accounting are not a single immutable concept but can and should be modified and adapted to the needs of specific decision-making processes and operating situations.[1]

It is evident from the foregoing that, since 1961, interest in the concepts of accrual accounting and cost-based budgeting within the Department of Defense has moderated. As a result, there has been little pressure on the military services to fully implement the policies set forth in Department of Defense Directives 7040.1 and 7040.2. For all practical purposes, their status can be described as at a standstill.

Department of Defense Cost Accounting Programs

While accrual accounting has receded in priority, there has been an increasing demand for more reliable cost information, particularly for pricing of programs under the Department of Defense programming system and for cost effectiveness studies. Citing the inadequacies of accounting in the military services, the study report on the programming system stated;

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[1]Daniel Borth, "Dynamic Accounting for Defense," The Federal Accountant, XIII (September, 1963), pp. 84-92.

> . . . Another serious deficiency, from the programming standpoint, is the strong emphasis which DoD accounting systems place on the discharge of accountability for appropriations, funds, and cash . . . rather than on cost information for management purposes.
>
> . . . .
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> . . . cost comparisons are hard to make and uniform programming procedures are difficult to install.[1]

In an article published in June 1962, the Department of Defense Comptroller indicated that efforts would be devoted to improving cost accounting in the military services:

> . . . There is a critical need at various levels of management for better cost data. Whether it be the cost of a squadron of MINUTEMAN missiles or the cost of handling a ton of aircraft spares at a depot, precise, up-to-date unit costs are essential for good estimating and decision making. It is this feedback of cost information that permits us to validate and improve our cost estimating, and this is an area which is sorely in need of improvement.[2]

Two recent Department of Defense programs are indicative of a direction towards installation of uniform cost accounting structures in operational management areas. A Department of Defense cost accounting program for maintenance activities was announced in August 1963, and, at the present time, a similar program for major supply activities is under development.

Department of Defense Instruction 7220.14 of August 14, 1963 established a uniform cost classification structure for depot maintenance operations. For the Navy, depot maintenance

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[1]U.S. Department of Defense, Study Report on the Programming System for the Office of the Secretary of Defense, 25 June 1962, p. IV - 4.

[2]Hitch, *op. cit.*, p. 42.

involves the level of repair and overhaul work performed, generally, by shipyards, repair facilities, air station overhaul and repair departments, and ammunition depots. The stated objective of the Instruction is to:

> . . . provide the framework for assembling and reporting comparable data on depot maintenance operations and accomplishments needed by management to measure productivity, to develop performance and cost standards, and to determine where the greatest emphasis for management improvement needs to be directed.[1]

Briefly, the program requires the collection of maintenance costs under a uniform structure of cost accounts identified by weapon system, support system, or material commodity group and provides for reporting to the Department of Defense. Costs to be collected include both funded and unfunded elements, including military personnel costs, distribution of overhead, and materials, supplies, and services on a consumption basis. Most of the Navy activities affected by the program operate under the Navy Industrial Fund with accrual accounting systems. Although such systems must be modified to accomodate the new cost account structure and reporting procedure, the basic accounting process exists to meet the requirements. For those activities not under an accrual accounting system, more fundamental changes are required.

The following statements in the implementing Navy instruction reveal an apparant lack of adequate coordination

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[1]U.S. Department of Defense Instruction 7220.14, Subject: Uniform Cost Accounting for Depot Maintenance, August 14, 1963.

with the military services in the development of this program:

> . . . Since the requirements of [Uniform Cost Accounting for Depot Maintenance] are stated in general terms, meetings were held with representatives of the Assistant Secretary of Defense (Comptroller) and the Assistant Secretary of Defense (Installations and Logistics) in order to clarify the intent of [DoD Instruction 7220.14] .
> . . . .
> In view of the various types of accounting systems now in effect in the Navy Department and the lack of sufficient planning and implementing time, deviations to some policies and procedures prescribed in [DoD Instruction 7220.14] and herein are granted on an interim basis until the accounting systems can be revised.[1]

It would appear from these statements that formulation and design of the program was exclusively a Department of Defense level project, stimulated predominantly by top level management considerations.

Another program now under development, and of a nature similar to the depot maintenance program, involves uniform cost accounting for major supply activities.[2] This program, if installed as proposed, will apply to all major supply activities, cargo terminals, and passenger terminals. Its objectives parallel those of the depot maintenance program, i.e., for management improvement, productivity measures, and development of performance and cost standards. The intention is to require installation of a uniform cost account structure for collection

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[1] U.S. Office of the Navy Comptroller, NAVCOMPT INSTRUCTION 7310.9, Subject: Uniform Cost Accounting for Depot Maintenance, November 29, 1963.

[2] U.S. Department of Defense Instruction (proposed), Subject: Uniform Cost Accounting for Major Supply Activities, 1964.

of costs according to supply functions performed, with reporting to the Department of Defense level.

Costs under this program, as defined in the proposed instruction, also include both funded and unfunded elements, including military personnel costs and overhead allocation. Since accrual accounting systems do not exist in the type of activities that would come under the scope of this program, substantial system changes would be necessary to install the type of cost accounting system contemplated in the proposed program.

CHAPTER VI

SUMMARY AND CONCLUSIONS

In review, the broad field of accounting in private industry can be dichotomized into two basic spheres, financial accounting and managerial accounting. The financial accounting functions are designed primarily with a historical perspective for recording and reporting financial status and operating results. Managerial accounting, on the other hand, is of a more dynamic nature and serves as an aid to internal management in planning and control of the enterprise. To serve management competently, the accounting system must generate information that is meaningful and reliable for planning and decision-making, that relates operating data to assignments of responsibility, and provides a basis for equating actual results to predetermined performance standards, plans, or other measures of effectiveness.

Although governmental operations differ in many respects from those of private industry, accounting is nevertheless equally important for management control in government, for:

> . . . The accounting function is one of the important keys to fast, accurate and successful decisions-whether they be made by business managers or by government administrators.[1]

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[1]H. Ladd Plumley, "Private Business Looks at the Federal Budget," The Federal Accountant, XIII (September, 1963), p. 32.

While the profit motive is missing in governmental operations, the need for economy and efficiency is not lacking. Without the inducement of competition to spur effective management, there is perhaps an even greater need for competent management control techiques to insure that resources are utilized to their best potential.

Until recent years, the traditional method of accounting in the Federal Government has been the cash and obligation basis, with records and reports stated in terms of contracts, orders, or commitments placed for material and services, and disbursements in payment therefor. Financial management centered primarily on administration of fund authorizations and most accounting effort was devoted to legal accountability functions. In the words of Ellsworth Morse:

> During the years of the vast expansion in the size and scope of Federal Government operations, starting about 30 years ago, necessary and desirable changes in financial management practices did not keep pace with such expansion, nor with changing concepts and methods. . . . although exceptions existed, agency accounting, for example, followed rigid patterns and was performed mainly to meet requirements imposed by the central fiscal agencies rather than adapted as necessary to the needs and purposes of the operating agencies. Accounting was essentially a means of evidencing fiscal accountability and compliance with legal limitations . . .[1]

During the past fifteen years, considerable attention has been devoted to improved management practices in the Federal Government. Legislation enacted since 1949 has called for

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[1]Ellsworth H. Morse, Jr., "The Joint Financial Management Improvement Program in the Federal Government," The Accounting Review, XXXVI (July, 1961), pp. 363.

sweeping changes in the Government's budgeting and accounting methods designed to energize the financial management process. Title IV of the National Security Act Amendments of 1949 and the Budget and Accounting Procedures Act of 1950 introduced important reforms, particularly the performance budget concept. Under the performance or program budget, the programs or activities of the agencies become the basis for the budget structure. The purpose is to present more meaningful budgets which reveal the nature of the work or functions of the agencies and the costs related to such activities. The idea behind the performance concept simply is to assemble the budgets in a more logical manner, to align costs to the programs or activities performed and thereby provide a rational foundation for budget decisions and for management in execution of the budget. The performance concept also called for program cost information in justification of the budget, to permit evaluation of cost of performance and comparisons within and between agencies.

The legislative requirement for accrual accounting and cost-based budgeting in the Federal Government was established with the enactment of Public Law 84-863 in August 1956. The primary purpose underlying this law was to strengthen financial management by shifting to a cost basis for budget formulation, justification, and execution, deemphasizing the traditional concentration on obligations as the basis for budget presentations and management control in Government. Under Public Law 84-863, the executive branch agencies are required to:

> . . . (1) make budget and accounting classifications consistent, and to match them with assigned operating responsibilities to the extent possible; (2) simplify the methods (i.e., the allotments) by which appropriated funds are made available for use by operating managers; (3) maintain accounts on the accrual basis, including monetary property records; and (4) modify budget practices to use cost information in support of appropriation requests and as a basic tool for managing activities in execution of the budget.[1]

In comparing the accrual accounting concept as it applies in private industry accounting to its meaning in the Federal Government, it becomes apparant that the term accrual accounting in government is used to describe a much broader concept. In private industry, accrual techniques are essential for accurate computation of financial status and measurement of net profit or loss for an accounting period. The accrual accounting concept in this respect refers primarily to the assignment of revenues and expenses to the proper accounting periods to which they relate, to facilitate the matching process. In the Federal Government, the question of measuring profit is generally non-existent, and only in the case of government corporations and commercial or industrial-type activities is there a regular need for matching revenue and expense of an accounting period. However, the purpose and meaning of accrual accounting in the Federal Government is of a much broader nature. One of its principal purposes is to shift the Government's accounts from

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[1]U.S. Secretary of the Treasury, Director, Bureau of the Budget, Comptroller General, Improvement of Financial Management in the United States Government, Progress 1948-1963 (Washington: Government Printing Office, 1964), p. 11.

the obligation basis of accounting to one of greater breadth and usefulness in management control. Under the accounting improvement program in the Federal Government:

> . . . managerial accounting is the major goal. This means fashioning accounting systems to develop accrual, cost, and fund information that meets the operating needs of responsible officials at the various levels of management. At the same time, it seeks full disclosure and essential safeguards over all available resources . . .[1]

While the assignment of revenues and expenses to the accounting periods to which they properly pertain is a central consideration in accrual accounting, as indicated by the term itself, this is but one facet of the accrual accounting program in the Federal Government. The scope of the accrual accounting objective is evident from the following statement from the Comptroller General's accounting principles and standards:

> The accrual basis of accounting should be employed by Federal agencies to produce improved accounting information and thereby increase the value of accounting to management and others by (1) contributing to full disclosure, (2) improving financial control over assets and liabilities, (3) aiding in the development of cost accounting, (4) providing more informative budget data, and (5) furnishing more significant accounting data which is related to specific assignments of managerial responsibility.[2]

Obviously, the term accrual accounting conveys too narrow a conception of the Government's accounting improvement program. It might better be titled conventional management

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[1] *Ibid.*, p. 19.

[2] U.S. General Accounting Office, *Policy and Procedures Manual for Guidance of Federal Agencies* (Washington: Government Printing Office, 1957), par. 1245.30.

accounting for it embraces more than simply the concept of recording revenue and expense on the accrual basis. Its basic intention is to develop accounting systems that will function as effective tools of management in planning and controlling the complex operations of the executive branch. The accounting improvements are aimed towards better management by:

> . . . providing prompt and significant cost information on carrying out assigned activities; by supplying a basis for making estimates of the cost of future operations; by furnishing a measure in financial terms of performance for comparison with planned objectives; and by providing the basic information needed to disclose fully - through periodic reports to higher management as well as to the public - current financial status and results of operations.[1]

In addition to accrual accounting and cost-based budgeting, the second Hoover Commission also stressed the desirability of eliminating the obligation based appropriation system in favor of appropriations stated in terms of estimated annual accrued expenditures. This proposal prompted considerable debate and failed of enactment. However, in 1958 Public Law 85-759 was passed and, while retaining obligation-type appropriations, did authorize the imposition of limitations on annual accrued expenditures, that is for goods and services received during the year. The underlying motivation of those who favored accrued expenditure limits was to establish greater control by Congress over Federal expenditures, in particular to provide for an annual review of the unexpended carryover appropriation balances. This concept offered little as a tool for better internal

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[1]Morse, _op_. _cit_., pp. 363-364.

management within the executive branch agencies. Accrued expenditures are not a measure of expenses, they do not represent expired costs, hence they are not a valid basis of measuring cost of performance any more than obligations are, except in those instances when accrued expenditures coincide with costs.

Besides an annual review of carryover programs, the only result that might have been derived from the accrued expenditures legislation was a more rigid expenditure control at the congressional level. However, even this objective was challenged because of the necessity to substitute contractual authorizations in place of obligational authority for long lead-time procurement programs which constitute a major part of the carryover appropriation balances. Furthermore, the wisdom of requiring the agencies to adhere to expenditure limits set in advance by Congress was also attacked as a possible impediment to efficient conduct of operations. Typical of the opposition to Congressional expenditure limitations were the following observations:

> . . . Expenditure control is a matter for the executive branch. Expenditure review based upon cash reports, cost based budgets and other reports giving the full picture of the receipt and use of resources would be a matter for the legislative branch . . .[1]

> . . . I do not quarrel with their advocating accrual accounting and cost budgeting as significant tools of management, but I do take issue with their advocating accrual accounting and cost budgeting as a tool for Congressional control of the purse strings.[2]

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[1]Lawrence E. Chermak, "Annual Accrued Expenditures," The Armed Forces Comptroller, III (June, 1958), p. 14.

[2]James F. Kelly, "Accrual Accounting and Cost Budgeting," An Interagency Panel, The Federal Accountant, XI (December, 1961), p. 86.

The accrued expenditure limitation authority was so poorly received by the House Committee on Appropriations that it never became operative during the life of Public Law 85-759 which expired in April, 1962. However, the controversy over the accrued expenditure funding concept did not involve a challenge to the validity of accrual accounting and cost-based budgeting. These tools can be employed usefully in Federal Government management within the obligation based appropriation structure. Their purpose is to emphasize costs in the management process. While obligation funding is a complicating factor, it does not preclude the use of costs as the foundation for accounting and budgeting, since costs can be reconciled to obligational authority. In fact, funding on the basis of obligational authority is desirable from the viewpoint of the executive branch agencies. It provides a measure of flexibility that would be lacking if congressional expenditure controls were instituted.

Progress in implementing accrual accounting in the Navy and throughout the Department of Defense has been stalled over the passed few years. This stalemate can be attributed principally to a shift in attention and effort to development and installation of the Department of Defense programming system. Without intending to deprecate the programming system, for it has proven merits for the purpose it serves, the fact is evident that it is designed primarily for planning, decision-making and control by top-level management. Its introduction accompanied the imposition of stronger direction by the Secretary of Defense

over planning, selection of major weapons systems and allocation of resources among the programs and functions of the military services. The programming system functions primarily in the upper levels of defense management and is concerned with the biggest decisions. It offers little in the way of improvement of day-to-day management at the lower operating levels. In fact, the Navy is not organizationally alligned for management under the Department of Defense programming structure. This was pointed out in the Navy's recent review of management:

> . . . management by OSD elements would pose a major problem in that the Department is geared to the management of resources such as: dollars, people, and material. Conversely, the Department is not organized in many respects to manage OSD elements. . . . Neither OSD major aggregations nor programs correspond directly to existing Department of the Navy programs or appropriation structure, or to the existing organizational structure . . .[1]

While the emergence of the programming system has sidetracked the accrual accounting and cost-based budgeting efforts, there is no conflict between these approaches. As a matter of fact, interest in cost comparisons stimulated by the programming system promotes the need for more reliable cost data. Although there has been no evidence of renewed pressure from the Department of Defense to proceed with the accrual accounting and cost-based budgeting programs on a broad basis, there has been, in recent months, indications of a need for accrual accounting in specific functional areas of support operations to compile cost

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[1]U.S. Department of the Navy, Planning, Programming, Budgeting, and Appraising Study, NAVEXOS P-2426B-2, (Washington: Government Printing Office, 1963), p. 81.

data under Department of Defense uniform cost accounting programs, specifically in maintenance and supply operations. Refined cost information of the type called for under these programs will necessitate well developed cost accounting systems and, at the least, modified accrual accounting. While these cost accounting programs indicate renewed emphasis on use of costs in operating management they, like the programming system, were designed primarily from the viewpoint of the upper echelons of management within the Department of Defense. Whether they will contribute significantly to improved management control at the installation level is open to challenge. Systems designed from a top level perspective may not be attuned to operating realities and, while serving the upper hierarchy, may accomplish little in promoting management effectiveness in the lower levels. On this point, Anthony criticizes that:

> . . . Many efforts start at the Pentagon or major command level and are overly concerned with the management needs at that level. The resulting system is designed more to meet these needs than the needs of operating executives in the field where the money is actually spent. A consequence of the top-down approach is that it is necessarily piecemeal because the complexities at the Pentagon level are so great that it is not feasible to take all of them into account in designing a single system.[1]

In citing how the Defense Department lags behind private industry in financial management, Anthony said:

> . . . A good business financial management system is a single system. It consists of a number of

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[1]Anthony, op. cit., p. 28.

> separate devices and techniques - budgeting, financial accounting, cost accounting, cost analysis, manpower controls and so on - but all the pieces fit together and are a part of a single management system. In the Defense Department, the separate pieces do not fit together. . . . the obligations systems do not coincide with the cost systems; program planning, financial planning and manpower planning come up with contradictory results for the same organization unit. True, these contradictions are much less now than they were a few years ago, but they still are serious and they result in a loss of respect for the whole idea of management control. . .[1]

In appraising the utility of the Navy's accounting systems in the financial management process, there are a number of creditable aspects to be recognized. Fund accounting is effective in its purpose, monetary property accounting exists, and there is a built in capability for wide use of cost accounting techniques. Business type financial management with fully developed accrual and cost accounting systems are installed in the industrial and commercial-type activities operating under the Navy Industrial Fund, and modified accrual and cost accounting systems are also installed in other specific operating areas. However, it is also evident that the primary emphasis of accounting for activities operated under appropriated funds is still on the control of fund authorizations, management type accounting is of secondary importance. Obligations and expenditures remain the basis for transaction recording. The general cost accounting system does not compile true cost information, but rather it is a system of expenditure analysis.

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[1]Anthony, op. cit., p. 24.

Great emphasis has been placed on cost consciousness in Navy management. At the very heart of management control is the fundamental responsibility of the manager to superintend the operations under his care so as to achieve effective performance with the least necessary costs. The essence of cost control lies in the relating of output or performance against some standard or yardstick of cost to evaluate efficiency. For the accounting system to effectively serve this purpose, it must funnel cost information to management so that the manager is aware of the costs he is supposed to control. The program budget, cost-based budget, and accrual accounting concepts are alike in this objective. The obligation basis of accounting, which remains the primary system of fund accounting in the Navy, fails to orient management towards a full appreciation of costs of operations, hence it does not generate the cost conscious attitude which is sought. The obligation accounting system encourages attention to use of funds. While fund control is an important aspect of financial management, overemphasis of this facet of control detracts from a coordinated approach to management and efficient utilization of all available resources. As Kohler and Wright have said:

> . . . Preoccupation with allotments, and with the obligations which it is the purpose of allotments to authorize, invites manipulations of inventories and unliquidated obligations, and detracts from the attention that should be given to controls over the consumption and costs of goods and services. If part of an allotment remains unobligated toward the

> close of a fiscal year or on the completion of a project, there is a temptation to obligate for unneeded additional inventory or fixed assets.[1]

This is not to imply that obligation accounting does not serve a useful purpose in some applications. Obligation control is, in fact, a meaningful basis of accounting for the long-term procurement programs. Even in private industry recognition is being given to the need for control at an early stage in the encumbrance of funds under capital asset procurement programs. This fact was cited by Murray Weidenbaum. In reference to the pioneering work being done by private industry in the fields of budgeting, financial control, and capital asset planning, he said:

> . . . this new work in the field of private accounting focuses on the early stages of the expenditure process. The control point is seen to be the appropriation by the company's board of directors for items to be constructed or produced over a relatively long period of time.[2]

However, in the management of operating type programs where there is a need for performance and cost comparisons, the obligation basis of accounting is deficient. In the military services, the operation and maintenance area of management is a fertile field for utilization of accrual accounting to foster effective management control. The obligation basis of accounting simply does not promote good management. It creates a frame of

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[1]Kohler and Wright, _op. cit._, p. 176.

[2]Murray L. Weidenbaum, "Improving the Federal Budget," _The Federal Accountant_, XIII (December, 1963), p. 108.

mind in the manager to control the use of funds to keep within a target, but it does not encourage him to assess the results of current operations against expired costs. In fact, it may even promote unwise expenditure of funds just to avoid returning unused fund balances for fear of possible reductions in subsequent period fund authorizations. The accrual basis of accounting, in contrast, can serve to promote a cost conscious outlook, since it focuses on the cost of resources used in achieving performance results during the accounting period. ". . . Accounting for resources used calls for a wholly different outlook on financial administration . . . A saving is something to be achieved if at all possible, rather than something to be avoided."[1]

Continuous surveillance of performance results and costs incurred is central to the process of management. The accrual system of accounting is designed for the express purpose of measuring period costs to the degree of accuracy needed. The cash or obligation bases produce only nebulous measures of costs, they mitigate the validity of any performance to cost comparisons, and they deny an incentive to the use of the cost approach in management. The accrual system of accounting is a necessary foundation on which to build a valid cost-based accounting and budgetary process to promote effective management control on a cost of performance basis.

While the accrual accounting objective has not yet been achieved within the Navy, a number of accounting improvements

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[1]Kohler and Wright, op. cit., p. 182.

have been installed under the stimulus of Public Law 84-863 and related accounting reform programs. Among the important accomplishments are the double entry system for fund accounting, controls over accounts receivable, simplification of the allotment system, and funding of work between allotments on a reimbursable basis. These are significant steps towards accrual accounting. Other features existing in the Navy's accounting systems also contribute to the objective. The extensive use of stock funds serves to defer end-use charges for material until time of issue from inventory. The expenditure account structure provides a basis for widespread use of cost accounting. But the fact remains that little progress has been made over the past few years to move closer to the ultimate objective. Diminution of emphasis on accounting improvements at the Department of Defense level has obviously been a vacillating influence on the accrual accounting efforts. As is universally true in all organizational activity, top level management support is a vital ingredient for successful pursuance of an objective. Renewal of the Navy's accounting improvement efforts will undoubtedly be influenced to a large degree by future developments regarding accounting policy at the Department of Defense level.

Conversion to the accrual basis is not an easy task and its full development will necessarily be a long-range process. Even in the civilian agencies of the Government, progress has been slow and considerable work remains to be done. The

military departments, by the very nature of their operations, are confronted with problems of greater complexity. Yet the difficulties that exist do not negate the benefits to be gained. There is flexibility in the accounting principles and standards to adapt the accrual basis to fit the requirements of a particular application and to limit the refinement of data according to need.

Accrual accounting is by no means the ultimate answer to sound financial management. It is just one element of an effective control system. But it is a necessary foundation for developing the full potential of managerial accounting. Program budgeting, cost-based budgeting and the cost approach in management control are predicated on it. Without the accrual system, the prospects are dubious of creating a genuine cost control climate at the operating levels of military management.

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APPENDIX

PUBLIC LAW 84-863

AN ACT

To improve governmental budgeting and accounting methods and procedures, and for other purposes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

AMENDMENTS TO THE BUDGET AND ACCOUNTING ACT, 1921

Sec. 1 (a) Section 201 of the Budget and Accounting Act, 1921, as amended (31 U. S. C. 11), is further amended by inserting "(a)" after the words "Sec. 201,"; by changing subsection (a) to subparagraph (1); by adding after subparagraph (1) a new subparagraph "(2) at such times as may be practicable, information on program costs and accomplishments"; by changing subsections (b) through (j) to subparagraphs (3) through (11), respectively.

(b) Section 216 of such Act, as amended (31 U. S. C. 24), is further amended by inserting "(a) after the words "Sec. 216." and adding the following new subsections:

"(b) The requests of the departments and establishments for appropriations shall, in such manner and at such times as may be determined by the President, be developed from cost-based budgets.

"(c) For purposes of administration and operation, such cost-based budgets shall be used by all departments and establishments and their subordinate units. Administrative subdivisions of appropriations or funds shall be made on the basis of such cost-based budgets."

AMENDMENTS TO THE BUDGET AND ACCOUNTING PROCEDURES ACT OF 1950

Sec. 2 (a) The Budget and Accounting Procedures Act of 1950 is amended by inserting after section 105 thereof the following new section:

"ACCOUNTING AND BUDGET CLASSIFICATIONS

"Sec. 106. The head of each executive agency shall, in consultation with the Director of the Bureau of the Budget, take whatever action may be necessary to achieve, insofar as is possible, (1) consistency in accounting and budget classifications, (2) synchronization between accounting and budget classifications and organizational structure, and (3) support of the budget justifications by information on performance and program costs by organizational units."

(b) Section 113 of such Act (31 U. S. C. 66a) is amended by adding at the end thereof the following new subsection:

"(c) As soon as practicable after the date of enactment of this subsection, the head of each executive agency shall, in accordance with principles and standards prescribed by the Comptroller General, cause the accounts of such agency to be maintained on an accrual basis to show the resources, liabilities, and costs of operations of such agency with a view to facilitating the preparation of cost-based budgets as required by section 216 of the Budget and Accounting Act, 1921, as amended. The accounting system required by this subsection shall include adequate monetary property accounting records as an integral part of the system."

(c) Section 118 of such Act is amended by inserting "113 (c)" after the words "section 111".

SIMPLIFICATION OF SYSTEM FOR SUBDIVIDING FUNDS

Sec. 3 Section 3679 (g), Revised Statutes, as amended (31 U. S. C. 665 (g)), is further amended by adding at the end thereof the following sentence: "In order to have a simplified system for the administrative subdivision of appropriations or funds, each agency shall work toward the objective of financing each operating unit, at the highest practical level, from not more than one administrative subdivision for each appropriation or fund affecting such unit."

Approved August 1, 1956